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TITLE XI − HIGHWAY REAUTHORIZATION AND EXCISE TAX SIMPLIFICATION

I. TRUST FUND REAUTHORIZATION

A. Extension of Highway Trust Fund and Aquatic Resources Trust Fund Expenditure Authority and Related Taxes (sec. 10002 of the House bill, secs. 5101 and 5102 of the Senate amendment, and secs. 4041, 4051, 4071, 4081, 4221, 4481, 4482, 4483, 6412, 9503, and 9504 of the Code)

Present-Law Highway Trust Fund Excise Taxes

In general

Six separate excise taxes are imposed to finance the Federal Highway Trust Fund program. Three of these taxes are imposed on highway motor fuels. Historically, fuel taxes have accounted for 90 percent of Highway Trust Fund receipts. The remaining three are a retail sales tax on heavy highway vehicles, a manufacturers' excise tax on heavy vehicle tires, and an annual use tax on heavy vehicles. The six taxes are summarized below. Except for 4.3 cents per gallon of the Highway Trust Fund fuels tax rates, and a portion of the tax on certain special motor fuels, all of these taxes, with the exception of the heavy vehicle use tax, are scheduled to expire after September 30, 2005.[1] The 4.3-cents-per-gallon portion of the fuels tax rates is permanent.[2] The six taxes are summarized below.

Highway motor fuels taxes

The Highway Trust Fund motor fuels tax rates are as follows:[3]

Gasoline	18.3 cents per gallon
Diesel fuel (including transmix) and kerosene	24.3 cents per gallon
Special motor fuels	18.3 cents per gallon, generally[4]

[1] The heavy vehicle use tax expires after September 30, 2006. Sec. 4481(f).

[2] This portion of the tax rates was enacted as a deficit reduction measure in 1993. Receipts from it were retained in the General Fund until 1997 legislation provided for their transfer to the Highway Trust Fund.

[3] These fuels also are subject to an additional 0.1-cent-per-gallon excise tax to fund the Leaking Underground Storage Tank ("LUST") Trust Fund (secs. 4041(d) and 4081(a)(2)(B)).

[4] The statutory rate for certain special motor fuels is determined on an energy equivalent basis, as follows:

Exemptions

Present law includes numerous exemptions (including partial exemptions) for specified uses of taxable fuels or for specified fuels. Because the gasoline and diesel fuel taxes generally are imposed before the end use of the fuel is known, many exemptions are realized through refunds to end users of tax paid by a taxpayer earlier in the distribution chain. Exempt uses and fuels include:

- use in State and local government and nonprofit educational organization highway vehicles;
- use in buses engaged in transporting students and employees of schools;
- use in local mass transit buses having a seating capacity of at least 20 adults (not including the driver) when the buses operate under contract with (or are subsidized by) a State or local governmental unit to furnish the transportation; and
- use in intercity buses serving the general public along scheduled routes. (Such use is totally exempt from the gasoline excise tax and is exempt from 17 cents per gallon of the diesel fuel tax.)

In addition, fuels used in off-highway business use or on a farm for farming purposes generally are exempt from these motor fuels taxes.[5] The Highway Trust Fund does not receive excise taxes imposed on fuel used in off-highway activities. Rather, when tax is imposed on off-highway use fuel consumption, it is used to finance other Trust Funds (e.g., motorboat gasoline and special motor fuel taxes from non-business off-highway use dedicated to the Aquatic Resources Trust Fund) or is retained in the General Fund (e.g., tax on diesel fuel used in trains).

Liquefied petroleum gas (propane)	13.6 cents per gallon (3.2 cents after September 30, 2005)
Liquefied natural gas	11.9 cents per gallon (2.8 cents after September 30, 2005)
Methanol derived from natural gas	9.15 cents per gallon (2.15 cents after September 30, 2005)
Compressed natural gas	48.54 cents per MCF

See secs. 4041(a)(2), 4041(a)(3) and 4041(m).

The compressed natural gas tax rate is equivalent only to 4.3 cents per gallon of the rate imposed on gasoline and other special motor fuels rather than the full 18.3-cents-per-gallon rate. The tax rate for the other special motor fuels is equivalent to the full 18.3-cents-per-gallon gasoline and special motor fuels tax rate.

[5] Diesel fuel is the same fuel (#2 fuel oil) as that commonly used as home heating oil. Fuel oil used as heating oil is not subject to the Federal excise tax.

Non-fuel Highway Trust Fund excise taxes

In addition to the highway motor fuels excise tax revenues, the Highway Trust Fund receives revenues produced by three excise taxes imposed exclusively on heavy highway vehicles or tires. These taxes are:

- a 12-percent excise tax imposed on the first retail sale of heavy highway vehicles, tractors, and trailers (generally, trucks having a gross vehicle weight in excess of 33,000 pounds and trailers having such a weight in excess of 26,000 pounds) (sec. 4051);
- an excise tax imposed on highway tires with a rated load capacity exceeding 3,500 pounds, generally at a rate of 9.45 cents per 10 pounds of excess (sec. 4071(a)); and
- an annual use tax imposed on highway vehicles having a taxable gross weight of 55,000 pounds or more (sec. 4481). (The maximum rate for this tax is $550 per year, imposed on vehicles having a taxable gross weight over 75,000 pounds.)

Present-Law Highway Trust Fund Expenditure Provisions

In general

Dedication of excise tax revenues to the Highway Trust Fund and expenditures from the Highway Trust Fund are governed by provisions of the Code.[6] The Code authorizes expenditures (subject to appropriations) from the Fund through July 27, 2005, for the purposes provided in authorizing legislation, as in effect on the date of enactment of the Surface Transportation Extension Act of 2005, Part IV.

Under present law, revenues from the highway excise taxes generally are dedicated to the Highway Trust Fund. However, under section 9503(c)(2), certain transfers are made from the Highway Trust Fund into the General Fund, relating to amounts paid in respect of gasoline used on farms, amounts paid in respect of gasoline used for certain nonhighway purposes or by local transit systems, amounts relating to fuels not used for taxable purposes, and income tax credits for certain uses of fuels.

Highway Trust Fund expenditure purposes

The Highway Trust Fund has a subaccount for Mass Transit. Both the Trust Fund and its sub-account are funding sources for specific programs. Neither the Highway Trust Fund nor its Mass Transit sub-account receive interest on unexpended balances. The Highway Fund's Mass Transit sub-account receives 2.86 cents per gallon of highway motor fuels excise taxes.

Highway Trust Fund expenditure purposes have been revised with each authorization Act enacted since establishment of the Highway Trust Fund in 1956. In general, expenditures

[6] Sec. 9503. The Highway Trust Fund statutory provisions were placed in the Internal Revenue Code in 1982.

authorized under those Acts (as the Acts were in effect on the date of enactment of the most recent such authorizing Act) are approved by the Code as Highway Trust Fund expenditure purposes.[7] Thus, no Highway Trust Fund monies may be spent for a purpose not approved by the tax-writing committees of Congress. The Code provides that authority to make expenditures from the Highway Trust Fund expires after July 27, 2005. Thus, no Highway Trust Fund expenditures may occur after July 27, 2005.

Anti-deficit provisions (the "Harry Byrd rule")

Highway projects can take multiple years to complete. As a result, the Highway Trust Fund carries positive unexpended balances, a large portion of which are reserved to cover existing obligations.[8] Highway Trust Fund spending is limited by anti-deficit provisions internal to the Highway Trust Fund, the so-called "Harry Byrd rule." Generally, the Harry Byrd rule prevents the further obligation of Federal highway funds if the current and expected balances of the Highway Trust Fund fall below a certain level. The rule requires the Treasury Department to determine, on a quarterly basis, the amount (if any) by which unfunded highway authorizations exceed projected net Highway Trust Fund tax receipts for the 24-month period beginning at the close of each fiscal year.[9] Similar rules apply to unfunded Mass Transit Account authorizations. If unfunded authorizations exceed projected 24-month receipts, apportionments to the States for specified programs funded by the relevant Trust Fund Account are to be reduced proportionately. Because of the Harry Byrd rule, taxes dedicated to the Highway Trust Fund typically are scheduled to expire at least 24 months after current authorizing Acts.

The Surface Transportation Extension Act of 2003, created a temporary rule (through February 29, 2004) for purposes of the anti-deficit provisions of the Highway Trust Fund. For purposes of determining 24 months of projected revenues for the anti-deficit provisions, the Secretary of the Treasury is instructed to treat each expiring provision relating to appropriations and transfers to the Highway Trust Fund to have been extended through the end of the 24-month period and to assume that the rate of tax during such 24-month period remains at the same rate in effect on the date of enactment of the provision. The temporary rule has been continuously

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[7] The authorizing Acts which currently are referenced in the Highway Trust Fund provisions of the Code are: the Highway Revenue Act of 1956; Titles I and II of the Surface Transportation Assistance Act of 1982; the Surface Transportation and Uniform Relocation Act of 1987; the Intermodal Surface Transportation Efficiency Act of 1991; and the Transportation Equity Act for the 21st Century; the Surface Transportation Extension Act of 2003; the Surface Transportation Extension Act of 2004; the Surface Transportation Extension Act of 2004 Part II; the Surface Transportation Extension Act of 2004, Part III; the Surface Transportation Extension Act of 2004, Part IV; the Surface Transportation Extension Act of 2004, Part V; the Surface Transportation Extension Act of 2005; the Surface Transportation Extension Act of 2005, Part II; the Surface Transportation Extension Act of 2005, Part III; and the Surface Transportation Extension Act of 2005, Part IV.

[8] Congressional Research Service, RL 32226, *Highway and Transit Program Reauthorization Legislation in the 2nd Session, 108th Congress* (December 15, 2004) at CRS-12.

[9] Sec. 9503(d).

extended since February 29, 2004. The last extension, enacted as part of the Surface Transportation Extension Act of 2005, Part IV, extended the rule through July 27, 2005.

Limitations on transfers to the Highway Trust Fund

The Code also contains a special enforcement provision to prevent expenditure of Highway Trust Fund monies for purposes not authorized in section 9503.[10] Should such unapproved expenditures occur, no further excise tax receipts will be transferred to the Highway Trust Fund. Rather, the taxes will continue to be imposed with receipts being retained in the General Fund. This enforcement provision provides specifically that it applies not only to unauthorized expenditures under the current Code provisions, but also to expenditures pursuant to future legislation that does not amend section 9503's expenditure authorization provisions or otherwise authorize the expenditure as part of a revenue Act.

Interrelationship of the Highway Trust Fund and the Aquatic Resources Trust Fund

The Aquatic Resources Trust Fund is funded by a portion of the receipts from the excise taxes imposed on motorboat gasoline and special motor fuels and on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment. A portion of these taxes are transferred into the Highway Trust Fund and then retransferred into the Aquatic Resources Trust Fund. As a result, transfers to the Aquatic Resources Trust Fund are governed in part by Highway Trust Fund provisions.[11]

A total tax rate of 18.4 cents per gallon is imposed on gasoline and special motor fuels used in motorboats and on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment. Of this rate, 0.1 cent per gallon is dedicated to the Leaking Underground Storage Tank Trust Fund. Of the remaining 18.3 cents per gallon, 4.8 cents per gallon are retained in the General Fund. The balance of 13.5 cents per gallon is transferred to the Highway Trust Fund and then retransferred to the Aquatic Resources Trust Fund and the Land and Water Conservation Fund, as follows.

The Aquatic Resources Trust Fund is comprised of two accounts, the Boat Safety Account and the Sport Fish Restoration Account. Motorboat fuel taxes, not exceeding $70 million per year, are transferred to the Boat Safety Account. In addition, these transfers are subject to an overall annual limit equal to an amount that will not cause the Boat Safety Account to have an unobligated balance in excess of $70 million. To the extent there are excess motorboat fuel taxes, the next $1 million per year of motorboat fuel taxes is transferred from the Highway Trust Fund to the Land and Water Conservation Fund provided for in Title I of the Land and Water Conservation Fund Act of 1965. The balance of the motorboat fuel taxes in the Highway Trust Fund is transferred to the Sport Fish Restoration Account.

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[10] Sec. 9503(b)(6).

[11] Secs. 9503(c)(4) and 9503(c)(5).

The Sport Fish Restoration Account also receives 13.5 cents per gallon of the small-engine fuel taxes from the Highway Trust Fund. This Account is also funded with receipts from an ad valorem manufacturers' excise tax on sport fishing equipment.

The retention in the General Fund of 4.8 cents per gallon of taxes on fuel used in motorboats and in the nonbusiness use of small-engine outdoor power equipment expires with respect to taxes imposed after September 30, 2005.

The expenditure authority for the Aquatic Resources Trust Fund expires after July 27, 2005.

House Bill

The expenditure authority for the Highway Trust Fund and Aquatic Resources Trust Fund is extended through September 30, 2009. The Code provisions governing the purposes for which monies in the Highway Trust Fund may be spent are modified to include the reauthorization bill.

The provision also extends the motor fuel taxes and all three non-fuel excise taxes at their current rates through September 30, 2011.

The provision does not extend the retention in the General Fund of 4.8 cents per gallon of taxes on fuel used in motorboats and in the nonbusiness use of small-engine outdoor power equipment.

Effective date.−The House bill is effective on the date of enactment.

Senate Amendment

The Senate amendment generally follows the House bill, but extends the retention in the General Fund of 4.8 cents per gallon of taxes on fuel used in motorboats and in the nonbusiness use of small-engine outdoor power equipment through September 30, 2011.

The Senate amendment also authorizes expenditures from the Highway Trust Fund for highway use tax evasion projects. Specifically, for fiscal years 2006 through 2009, the Internal Revenue Service is to receive $120 million for the enforcement of fuel tax compliance, including the precertification of tax-exempt users, and $80 million for the excise fuel information reporting system, of which $40 million is to be allocated to the excise summary terminal activity reporting system. In addition, for each of the fiscal years 2006 through 2009, $50 million is authorized for the Federal Highway Administration to allocate $1 million to each State to combat fuel tax evasion on the State level.

The Senate amendment also changes the Harry Byrd rule from a 24-month to a 48-month receipt rule. Under the Senate amendment, the Harry Byrd rule is not triggered unless unfunded highway authorizations exceed projected net Highway Trust Fund tax receipts for the 48-month period beginning at the close of each fiscal year. For purposes of the 48-month rule, taxes are assumed extended beyond their expiration date.

Effective date.−The Senate amendment is effective on the date of enactment.

Conference Agreement

The conference agreement follows the House bill with the following modifications. The expenditure authority for the Highway Trust Fund expires after September 29, 2009, (after September 30, 2009, in the case of expenditures for administrative purposes, and expenditures from the Mass Transit Account).

The conference agreement changes the Harry Byrd rule from a 24-month to a 48-month receipt rule. Under the conference agreement, the Harry Byrd rule is not triggered unless unfunded highway authorizations exceed projected net Highway Trust Fund tax receipts for the 48-month period beginning at the close of each fiscal year. For purposes of the 48-month rule, taxes are assumed extended beyond their expiration date.

The conference agreement does not extend the General Fund retention of taxes on fuel used in motorboats and in the nonbusiness use of small-engine outdoor power equipment. The conference agreement addresses authorization of expenditures for fuel tax compliance elsewhere in the conference agreement and does not amend the Code for this purpose.

II. EXCISE TAX REFORM AND SIMPLIFICATION

A. Highway Excise Taxes

1. Modify gas guzzler tax (sec. 5201 of the Senate amendment and sec. 4064 of the Code)

Present Law

Under present law, the Code imposes a tax ("the gas guzzler tax") on automobiles that are manufactured primarily for use on public streets, roads, and highways and that are rated at 6,000 pounds unloaded gross vehicle weight or less.[12] The tax applies to limousines without regard to the weight requirement. The tax is imposed on the sale by the manufacturer of each automobile of a model type with a fuel economy of 22.5 miles per gallon or less. The tax range begins at $1,000 and increases to $7,700 for models with a fuel economy less than 12.5 miles per gallon.

Emergency vehicles and non-passenger automobiles are exempt from the tax. The tax also does not apply to non-passenger automobiles. The Secretary of Transportation determines which vehicles are "non-passenger" automobiles, thereby exempting these vehicles from the gas guzzler tax based on regulations in effect on the date of enactment of the gas guzzler tax.[13] Hence, vehicles defined in Title 49 C.F.R. sec. 523.5 (relating to light trucks) are exempt. These vehicles include those designed to transport property on an open bed (e.g., pick-up trucks) or provide greater cargo-carrying than passenger carrying volume including the expanded cargo-carrying space created through the removal of readily detachable seats (e.g., pick-up trucks, vans, and most minivans, sports utility vehicles and station wagons). Additional vehicles that meet the "non-passenger" requirements are those with at least four of the following characteristics: (1) an angle of approach of not less than 28 degrees; (2) a breakover angle of not less than 14 degrees; (3) a departure angle of not less than 20 degrees; (4) a running clearance of not less than 20 centimeters; and (5) front and rear axle clearances of not less than 18 centimeters each. These vehicles would include many sports utility vehicles.

House Bill

No provision.

Senate Amendment

The Senate amendment repeals the tax as it applies to limousines rated at greater than 6,000 pounds unloaded gross vehicle weight.

Effective date.−The Senate amendment is effective on October 1, 2005.

[12] Sec. 4064.

[13] Sec. 4064(b)(1)(B).

Conference Agreement

The conference agreement follows the Senate amendment provision.

2. Exclusion for tractors weighing 19,500 pounds or less from excise tax on heavy trucks and trailers (sec. 5202 of the Senate amendment and sec. 4051 of the Code)

Present Law

A 12-percent excise tax is imposed on the first retail sale of automobile truck chassis and bodies, truck trailer and semitrailer chassis and bodies, and tractors of the kind chiefly used for highway transportation in combination with a trailer or semitrailer.[14] The tax does not apply to automobile truck chassis and bodies suitable for use with a vehicle which has a gross vehicle weight of 33,000 pounds or less.[15] The tax also does not apply to truck trailer and semitrailer chassis and bodies suitable for use with a trailer or semitrailer which has a gross vehicle weight of 26,000 pounds or less.[16] In general, tractors are subject to tax regardless of their gross vehicle weight.

Temporary Treasury regulations provide that "tractor" means a highway vehicle which is primarily designed to tow a vehicle, such as a trailer or semitrailer, but which does not carry cargo on the same chassis as the engine. The regulations presume that a vehicle equipped with air brakes and/or towing package is primarily designed as a tractor.[17] The regulations further require an incomplete chassis cab to be treated as a tractor if it is equipped with any of the safety devices listed in the regulations, and require that it be treated as a truck if it is not equipped with any of the listed safety devices and the purchaser certifies in writing that the vehicle will not be equipped for use as a tractor.[18]

In *Freightliner of Grand Rapids, Inc. v. U.S.*, the district court held that certain vehicles primarily designed to tow large RV trailers but which had some cargo carrying capacity on their chassis are properly characterized as tractors.[19] The court also held that incomplete chassis cabs that do not include any of the listed safety devices are to be treated as tractors unless the purchaser certifies in writing that it will not equip the vehicles for use as tractors. Under the holding of this case, these types of vehicles are subject to tax regardless of their gross vehicle weight.

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[14] Sec. 4051(a)(1).

[15] Sec. 4051(a)(2).

[16] Sec. 4051(a)(3).

[17] Temp. Treas. Reg. sec. 145.4051-1(e)(1)(i).

[18] Temp. Treas. Reg. sec. 145.4051-1(e)(1)(ii).

[19] 351 F.Supp.2d 718 (W.D. Mich. 2004).

House Bill

No provision.

Senate Amendment

The Senate amendment excludes from tax tractors with a gross vehicle weight of 19,500 pounds or less.

Effective date.−The Senate amendment is effective for sales after September 30, 2005.

Conference Agreement

The conference agreement follows the Senate amendment except that it also requires that in order to be exempt the gross combined weight (as determined by the Secretary) of the tractor if combined with a towed vehicle (such as trailer or semi-trailer) would not exceed 33,000 pounds. No inference is intended from this provision regarding the proper classification of vehicles as tractors or trucks.

3. Exemption for bulk beds from excise tax on retail sale of heavy trucks and trailers (sec. 5203 of the Senate amendment)

Present Law

The Code imposes a 12-percent excise tax on the first retail sale of heavy trucks and trailers (chassis and bodies).[20] Under present law, the tax on the first retail sale of automobile truck bodies does not apply to any body primarily designed: (1) to process or prepare seed, feed, or fertilizer for use on farms; (2) to haul feed, seed, or fertilizer to and on farms; (3) to spread feed, seed, or fertilizer on farms; (4) to load or unload feed, seed, or fertilizer on farms; or (5) for any combination of the foregoing.[21]

The IRS has issued various rulings in this area. In Revenue Ruling 69-579, the IRS found that a truck body used primarily for hauling animal and poultry feed to and unloading it on farms qualified for exemption because the built-in equipment was elaborate and expensive. Thus, the IRS concluded that the nature of the unloading systems made it impractical to purchase the bodies for use other than in hauling feed, seed, or fertilizer to and unloading it on farms.

In 1975, the IRS ruled as not exempt a dump truck designed for and used primarily in hauling grain and sugar beets from the field to points on or off the farm but which may also be used to haul feed or fertilizer from a distribution point over the highway to the farm. The ruling concluded that bodies that are used for the general hauling of feed, seed, or fertilizer over the highway are subject to the tax unless they have specific features that indicate they are primarily

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[20] Sec. 4051(a).

[21] Sec. 4053(2).

designed to haul feed, seed, or fertilizer to and on farms. In this case, although feed and fertilizer were among the commodities that the dump truck could be used for, it did not have specific features to indicate that it was primarily designed to haul feed, seed, or fertilizer to and on farms.[22]

In 1990, the IRS issued a technical advice memorandum ("the 1990 TAM") that concluded that a type of truck bought by farmers to haul seed potatoes, sugar beets, grain, and other farm products qualified for exemption.[23] Each model had a full-length, powered conveyor belt that was designed to support and unload the cargo; a powered rear discharge door to control the discharge rate of the cargo; and a standard universal motor mount to which an electric drive could be mounted. In that ruling, the IRS noted the special unloading equipment was elaborate and expensive, added substantially to the cost and weight of each body, and limited its load-carrying capabilities.

In 1999, the IRS revoked the 1990 TAM prospectively, noting that the exemption was not intended to cover truck bodies designed for general use, even if capable of hauling feed, seed, or fertilizer to and on farms.[24] The IRS noted that the sales literature indicated that the body was designed to be versatile for hauling potatoes, beets, and small grains. The IRS also observed that unlike the bodies described in Rev. Rul. 69-579, which would not be purchased for use other than in hauling feed, seed, or fertilizer, the bodies at issue are designed for general hauling of farm cargo. Further, the IRS found that the presence of a conveyor belt was equally useful for unloading a crop at market as it is for unloading feed, etc. on a farm. Thus, the IRS concluded that the truck body was not primarily designed for an exempt purpose.

House Bill

No provision.

Senate Amendment

The Senate amendment exempts bulk beds used for transporting farm crops to and on farms from the excise tax on the retail sale of heavy trucks and trailers if sold to a person who certifies to the seller that such person is actively engaged in the trade or business of farming and the primary use of the bulk bed is to haul to and on farms farm crops grown in connection with such trade or business. The Senate amendment provides for the recapture of the tax from the purchaser upon resale of within two years of the first retail sale, or if such purchaser makes substantial nonexempt use of the article.

Effective date.−The Senate amendment is effective for sales after September 30, 2005.

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[22] Rev. Rul. 75-462.

[23] Tech. Adv. Mem. 9126001, 1991 WL 778984 (1991).

[24] Tech. Adv. Mem. 199904038, 1999 WL 36828 (1999).

Conference Agreement

The conference agreement does not include the Senate amendment provision.

4. Volumetric excise tax credit for alternative fuels (sec. 5204 of the Senate amendment and secs. 4041, 4101, 6426, and 6427 of the Code)

Present Law

Under section 4081 of the Code, an excise tax is imposed upon (1) the removal of any taxable fuel from a refinery or terminal, (2) the entry of any taxable fuel into the United States, or (3) the sale of any taxable fuel to any person who is not registered with the IRS to receive untaxed fuel, unless there was a prior taxable removal or entry.[25] The tax does not apply to any removal or entry of taxable fuel transferred in bulk by pipeline or vessel to a terminal or refinery if the person removing or entering the taxable fuel, the operator of such pipeline or vessel, and the operator of such terminal or refinery are registered with the Secretary.[26] Section 4081 also imposes an excise tax on taxable fuel removed or sold by the blender of the fuels.[27] However, the blender is entitled to a credit on any tax previous paid if that person establishes the amount of such tax.[28] A "taxable fuel" is gasoline, diesel fuel (including any liquid, other than gasoline, which is suitable for use as a fuel in a diesel-powered highway vehicle or train), and kerosene.[29]

Diesel fuel and kerosene generally are taxed at 24.3 cents per gallon excise (aviation-grade kerosene at 21.8 cents per gallon). Gasoline is taxed at 18.3 cents per gallon and aviation gasoline is taxed at 19.3 cents per gallon.

The Code imposes a backup retail tax for diesel fuel and kerosene not taxed under section 4081, and for special motor fuels.[30] Under section 4041, tax is imposed on special motor fuels (any liquid other than gas oil, fuel oil or any product taxable under section 4081) when there is a taxable sale by any person to an owner, lessee or other operator of a motor vehicle or motorboat,

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[25] Sec. 4081(a)(1).

[26] Sec. 4081(a)(1)(B).

[27] Sec. 4081(b)(1). Blended taxable fuel is a taxable fuel that is produced outside the bulk transfer/terminal system by mixing taxpayer fuel with respect to which tax has been imposed under section 4041(a)(1) or 4081(a) (other than taxable fuel for which a credit or payment has been allowed); and any other liquid on which tax has not been imposed under section 4081. Treas. Reg. sec. 48.4081-1(c)(i).

[28] Sec. 4081(b)(2).

[29] Sec. 4083(a).

[30] Sec. 4041.

for use as fuel in the motor vehicle or motorboat or used by any person as a fuel in a motor vehicle or motorboat unless there was a prior taxable sale.[31]

Most special motor fuels are subject to tax at 18.3 cents per gallon, however, certain special motor fuels and compressed natural gas are determined on an energy equivalent basis, as follows:

Liquefied petroleum gas (propane)	13.6 cents per gallon
Liquefied natural gas	11.9 cents per gallon
Methanol derived from petroleum or natural gas	9.15 cents per gallon
Compressed natural gas	48.54 cents per MCF

Liquid hydrogen is a special motor fuel for purposes of the tax on special motor fuels and is subject to a tax of 18.3 cents per gallon.[32] Compressed hydrogen gas used or sold as a fuel is not subject to tax.

Prior to the American Jobs Creation Act of 2004, gasohol and gasoline to be blended into gasohol was taxed at a reduced rate based on the amount of ethanol contained in the mixture (e.g., 10 percent, 7.7 percent or 5.5 percent alcohol in the mixture). The Act eliminated reduced rates of excise tax for most alcohol-blended fuels. In place of the reduced rates, the Act amended the Code to create two new excise tax credits: the alcohol fuel mixture credit and the biodiesel mixture credit.[33] The sum of these credits may be taken against the tax imposed on taxable fuels (by section 4081). A person may also file a claim for payment equal to the amount of these credits for biodiesel or alcohol used to produce an eligible mixture.[34] The credits and payments are paid out of the General Fund. If the alcohol is ethanol with a proof of 190 or greater, the credit or payment amount is 51 cents per gallon. For agri-biodiesel, the credit or payment amount is $1.00 per gallon; for biodiesel other than agri-biodiesel, the credit or payment amount is 50 cents per gallon. Under the Code's coordination rules, a claim may be taken only once with respect to any particular gallon of alcohol or biodiesel.

No excise tax credit is available for the blending or sale of special motor fuels.

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[31] Sec. 4041(a)(2).

[32] An additional 0.1 cent per gallon is imposed by section 4041(d) for the Leaking Underground Storage Tank Trust Fund.

[33] Sec. 6426. The Act also created an income tax credit for biodiesel and biodiesel mixtures. Sec. 40A.

[34] Sec. 6427(e).

House Bill

No provision.

Senate Amendment

Under the Senate amendment, P Series fuels (as defined by the Secretary of Energy under 42 U.S.C. sec. 13211(2)) are taxed at 18.3 cents per gallon under section 4081. Compressed natural gas and hydrogen are taxed at 18.3 cents per energy equivalent of a gallon of gasoline, and liquefied natural gas, any liquid fuel (other than methanol or ethanol) derived from coal and liquid hydrocarbons derived from biomass are taxed at 24.3 cents per gallon under section 4081. Collectively, these fuels are referred to as "alternative fuels."

In addition, the Senate amendment creates two new excise tax credits, the alternative fuel credit, and the alternative fuel mixture credit. The credits are allowed against section 4081 liability. The alternative fuel credit is 50 cents per gallon of alternative fuel or gasoline gallon equivalents of nonliquid alternative fuel sold by the taxpayer for use as a motor fuel in a highway vehicle. The alternative fuel mixture credit is 50 cents per gallon of alternative fuel used in producing an alternative fuel mixture for sale or use in a trade or business of the taxpayer. The mixture must be sold by the taxpayer for use as a fuel in a highway vehicle or used by the taxpayer as a fuel in a highway vehicle. Liquid fuel derived from coal would only qualify for the credits if derived from the Fischer-Tropsch process. The credits generally expire after September 30, 2009. The proposal also allows persons to file a claim for payment equal to the amount of the alternative fuel credit and alternative fuel mixture credits. These payment provisions generally also expire after September 30, 2009. Both credits and payments are made out of the General Fund. Under coordination rules, a claim for payment or credit may only be taken once with respect to any particular gallon or gasoline-gallon equivalent of alternative fuel.

Effective date.−The Senate amendment is effective for any sale, use or removal for any period after September 30, 2006.

Conference Agreement

The conference agreement follows the Senate amendment with the following modifications.

Under the conference agreement, liquefied petroleum gas and P Series fuels (as defined by the Secretary of Energy under 42 U.S.C. sec. 13211(2)) are taxed at 18.3 cents per gallon under section 4041. Compressed natural gas is taxed at 18.3 cents per energy equivalent of a gallon of gasoline. Liquefied natural gas, any liquid fuel derived from coal (other than ethanol or methanol) and liquid hydrocarbons derived from biomass are taxed at 24.3 cents per gallon under section 4041. The conference agreement does not change the tax treatment of hydrogen, liquefied hydrogen remains subject to the tax imposed by section 4041.

In addition, the conference agreement creates two new excise tax credits, the alternative fuel credit, and the alternative fuel mixture credit. For this purpose, the term "alternative fuel" means liquefied petroleum gas, P Series fuels (as defined by the Secretary of Energy under 42 U.S.C. sec. 13211(2)), compressed or liquefied natural gas, liquefied hydrogen, liquid fuel

derived from coal through the Fisher-Tropsch process, and liquid hydrocarbons derived from biomass. Such term does not include ethanol, methanol, or biodiesel.

The alternative fuel credit is allowed against section 4041 liability and the alternative fuel mixture credit is allowed against section 4081 liability. Neither credit is allowed unless the taxpayer is registered with the Secretary. The alternative fuel credit is 50 cents per gallon of alternative fuel or gasoline gallon equivalents[35] of nonliquid alternative fuel sold by the taxpayer for use as a motor fuel in a motor vehicle or motorboat, or so used by the taxpayer.

The alternative fuel mixture credit is 50 cents per gallon of alternative fuel used in producing an alternative fuel mixture for sale or use in a trade or business of the taxpayer. The mixture must be sold by the taxpayer producing such mixture to any person for use as a fuel or used by the taxpayer for use as a fuel.[36] The credits generally expire after September 30, 2009. The provision also allows persons to file a claim for payment equal to the amount of the alternative fuel credit and alternative fuel mixture credits. These payment provisions generally also expire after September 30, 2009. With respect to liquefied hydrogen, the credit and payment provisions expire after September 30, 2014. Both credits and payments are made out of the General Fund. Under coordination rules, a claim for payment or credit may only be taken once with respect to any particular gallon or gasoline-gallon equivalent of alternative fuel.

Effective date.−The provision is effective for any sale or use for any period after September 30, 2006.

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[35] "Gasoline gallon equivalent" means, with respect to any nonliquid alternative fuel, the amount of such fuel having a Btu content of 124,800 (higher heating value).

[36] For example, the taxpayer produces fish oil in its trade or business. The taxpayer uses this fish oil to make a blend of 50 percent fish oil and 50 percent diesel fuel to run in a generator that is part of the taxpayer's trade or business. This use of the fish oil-diesel blend made by the taxpayer qualifies as use of an alternative fuel mixture for purposes of the requirement that the fuel be used in the blender's trade or business.

B. Aquatic Excise Taxes

1. Eliminate Aquatic Resources Trust Fund and transform Sport Fish Restoration Account (sec. 5211 of the Senate amendment and secs. 9503 and 9504 of the Code)

Present Law

A total tax rate of 18.4 cents per gallon is imposed on gasoline and special motor fuels used in motorboats, and on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment.[37] Of this rate, 0.1 cent per gallon is dedicated to the Leaking Underground Storage Tank Trust Fund. Of the remaining 18.3 cents per gallon, tax collected in excess of 13.5 cents per gallon (i.e., 4.8 cents per gallon) is retained in the General Fund of the Treasury.[38] The balance is transferred to the Highway Trust Fund, and retransferred (except with respect to amounts transferred to the fund for land and water conservation, as described below) to the Aquatic Resources Trust Fund.[39] The taxes on gasoline and special motor fuels used in motorboats and the taxes on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment are collected under the same rules as apply to the Highway Trust Fund collections generally.

The Aquatic Resources Trust Fund is comprised of two accounts.[40] First, the Boat Safety Account is funded by a portion of the receipts from the excise tax imposed on motorboat gasoline and special motor fuels. Transfers to the Boat Safety Account are limited to amounts not exceeding $70 million per year. In addition, these transfers are subject to an overall annual limit equal to an amount that will not cause the Boat Safety Account to have an unobligated balance in excess of $70 million.[41]

Second, the Sport Fish Restoration Account receives the balance of the motorboat gasoline and special motor fuels receipts that are transferred to the Aquatic Resources Trust

[37] Sec. 4081(a)(2).

[38] The retention in the General Fund of the 4.8 cents a gallon of motorboat fuel taxes and taxes on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment expires after September 30, 2005.

[39] Sec. 9503(c)(4). Between October 1, 2001 and September 30, 2003, the amount transferred to the Highway Trust Fund was 13 cents per gallon. Prior to October 1, 2001, the amount transferred was 11.5 cents per gallon. Sec. 9503(b)(4)(D). The transfers from the Highway Trust Fund to the Aquatic Resources Trust Fund of amounts of taxes received on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment expires after September 30, 2005. Sec. 9503(c)(5).

[40] Sec. 9504(a).

[41] Sec. 9503(c)(4)(A). Funding of the Boat Safety Account is scheduled to expire after September 30, 2005.

Fund.[42] The Sport Fish Restoration Account is also funded with receipts from an excise tax on sport fishing equipment sold by the manufacturer, producer or importer. The excise tax rate on sport fishing equipment is 10 percent of the sales price; the rate is reduced to 3 percent for electric outboard motors and fishing tackle boxes.[43] Examples of the items of sport fishing equipment subject to the 10-percent rate include fishing rods and poles, fishing reels, fly fishing lines and certain other fishing lines, fishing spears, spear guns, spear tips, items of terminal tackle, containers designed to hold fish, fishing vests, landing nets, and portable bait containers.[44] In addition, import duties on certain fishing tackle, yachts and pleasure craft are transferred into the Sport Fish Restoration Account.

The amounts of taxes on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment that are transferred to the Highway Trust Fund and retransferred to the Aquatic Resources Trust Fund are directed to a separate sub-account of the Sport Fish Restoration Account, the Coastal Wetlands Sub-Account.

Expenditures from the Boat Safety Account are subject to annual appropriations. Amounts transferred, paid, or credited to the Sport Fish Restoration Account (including the Coastal Wetlands Sub-Account) are authorized to be appropriated for the uses authorized in the expenditure provisions.[45]

House Bill

No provision.

Senate Amendment

The Senate amendment eliminates the Aquatic Resources Trust Fund and future transfers to the Boat Safety Account and transforms the Sport Fish Restoration Account into the Sport Fish Restoration and Boating Trust Fund. After funding of the land and water conservation fund as under present law, the balance of the taxes on motorboat fuels is transferred from the Highway Trust Fund into the Sport Fish Restoration and Boating Trust Fund. In addition, the transfers from the Highway Trust Fund to the Sport Fish Restoration and Boating Trust Fund of amounts

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[42] After funding of the Boat Safety Account, remaining motorboat fuel taxes, not exceeding $1,000,000 during any fiscal year, are transferred from the Highway Trust Fund into the land and water conservation fund provided in Title I of the Land and Water Conservation Fund Act of 1965. Sec. 9503(c)(4)(B). After the transfer to the land and water conservation fund, motorboat fuel taxes remaining in the Highway Trust Fund are transferred to the Sport Fish Restoration Account. Sec. 9503(c)(4)(C).

[43] Sec. 4161(a)(2) and 4161(a)(c)(3).

[44] Items of "sport fishing equipment" are enumerated in section 4162(a).

[45] Act of August 9, 1950, 64 Stat. 430 (codified at 16 U.S.C. sec. 777 et seq.) ("An Act to provide that the United States shall aid the States in fish restoration and management projects, and for other purposes," commonly referred to as the Dingell-Johnson Sport Fish Restortation Act.).

of taxes on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment are extended through September 30, 2011.

Existing amounts in the Boat Safety Account, plus interest accrued on interest-bearing obligations of such account, are made available as provided under expenditure provisions.[46] The expenditure provisions also authorize the appropriation of amounts in the Sport Fish Restoration and Boating Trust Fund, including for boating safety, for the uses authorized in the expenditure provisions.

Effective date.−The Senate amendment is effective October 1, 2005.

Conference Agreement

The conference agreement follows the Senate amendment.

2. Repeal of harbor maintenance tax on exports (sec. 5212 of the Senate amendment and sec. 4461 of the Code)

Present Law

The Code contains provisions imposing a 0.125-percent excise tax on the value of most commercial cargo loaded or unloaded at U.S. ports (other than ports included in the Inland Waterway Trust Fund system). The tax also applies to amounts paid for passenger transportation using these U.S. ports. Exemptions are provided for (1) cargo donated for overseas use, (2) cargo shipped between the U.S. mainland and Alaska (except for crude oil), Hawaii, and/or U.S. possessions and (3) cargo shipped between Alaska, Hawaii, and/or U.S. possessions. Receipts from this tax are deposited in the Harbor Maintenance Trust Fund.

The U.S. Supreme Court has held that the harbor maintenance excise tax is unconstitutional as applied to exported cargo because it violates the "Export Clause" of the U.S. Constitution.[47] The tax remains in effect for imported cargo. Imposition of the tax on passenger transportation with respect to passengers on cruises that originate, stop, or terminate, at U.S. ports has been upheld.

House Bill

No provision.

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[46] The expenditure provisions are codified at 16 U.S.C. sec. 777 et seq., as may be amended by the Sportfishing and Recreational Boating Safety Act of 2005.

[47] *United States Shoe Corp. v. United States*, 523 U.S. 360, 118 S. Ct. 1290, 140 L. Ed. 2d 453 (1998).

Senate Amendment

The Senate amendment conforms the Code to the Supreme Court decision and exempts exported commercial cargo from the harbor maintenance tax.

Effective date.−The Senate amendment is effective before, on, and after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

3. Cap on excise tax on certain fishing equipment (sec. 5213 of the Senate amendment and sec. 4161 of the Code)

Present Law

In general, the Code imposes a 10-percent tax on the sale by the manufacturer, producer, or importer of specified sport fishing equipment.[48] A three-percent rate, however, applies to the sale of electric outboard motors and fishing tackle boxes.[49] Sport fishing equipment subject to the 10-percent tax includes fishing rods and poles, fishing reels, fly fishing lines, and other fishing lines not over 130 pounds test, fishing spears, spear guns, and spear tips, and tackle items including leaders, artificial lures, artificial baits, artificial flies, fishing hooks, bobbers, sinkers, snaps, drayles, and swivels. In addition the following fishing supplies and accessories are subject to the 10-percent tax: fish stringers; creels; bags, baskets, and other containers designed to hold fish; portable bait containers; fishing vests; landing nets; gaff hooks; fishing hook disgorgers; dressing for fishing lines and artificial flies; fishing tip-ups and tilts; fishing rod belts, fishing rodholders; fishing harnesses; fish fighting chairs; and fishing outriggers and downriggers.

Revenues from the excise tax on sport fishing equipment are deposited in the Sport Fish Restoration Account of the Aquatic Resources Trust Fund. Monies in the fund are spent, subject to an existing permanent appropriation, to support Federal-State sport fish enhancement and safety programs.

House Bill

No provision.

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[48] Sec. 4161(a)(1).

[49] Sec. 4161(a)(2) and 4161(a)(3).

Senate Amendment

The Senate amendment provides that the tax applicable to a fishing rod or fishing pole is the lesser of 10 percent or $10.00.

Effective date.−The Senate amendment is effective for articles sold by the manufacturer, producer, or importer after September 30, 2005.

Conference Agreement

The conference agreement follows the Senate amendment.

C. Aerial Excise Taxes

1. Clarification of excise tax exemptions for agricultural aerial applicators and exemption for fixed-wing aircraft engaged in forestry operations (sec. 5221 of the Senate amendment and secs. 4261 and 6420 of the Code)

Present Law

Excise taxes are imposed on aviation gasoline (19.4 cents per gallon) and jet fuel (21.9 cents per gallon).[50] All but 0.1 cent per gallon of the revenues from these taxes are dedicated to the Airport and Airway Trust Fund. The remaining 0.1 cent per gallon rate is imposed for the Leaking Underground Storage Tank Trust Fund.

Fuel used on a farm for farming purposes is a nontaxable use. Aerial applicators (crop dusters) are allowed to claim a refund instead of farm owners and operators in the case of aviation gasoline if the owners or operators give written consent to the aerial applicators.[51] This provision applies only to fuel consumed in the airplane while operating over the farm, i.e., fuel consumed traveling to and from the farm is not exempt.

Air passenger transportation is subject to an excise tax equal to 7.5 percent of the amount paid plus $3.20 per domestic flight segment.[52] The tax on transportation by air does not apply to air transportation by helicopter if the helicopter is used for (1) the exploration, or the development or removal of oil, gas, or hard minerals exploration, or (2) certain timber operations (planting, cultivating, cutting, transporting, or caring for trees, including logging operations).[53] The exemption applies only when the helicopters are not using the Federally funded airport and airway services. Helicopters and fixed-wing aircraft providing emergency medical services also are exempt from the air passenger tax regardless of the type of airport and airway services used.[54]

House Bill

No provision.

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[50] Sec. 4081.

[51] Sec. 6420(c)(4)).

[52] Sec. 4261(a) and 4261(b).

[53] Sec. 4261(f).

[54] Sec. 4261(g).

Senate Amendment

With regard to the exemption for aerial applicators, written consent from the farm owner or operator is no longer needed for the aerial applicator to claim exemption for aviation gasoline. The exemption also is expanded to include fuels consumed when flying between the farms where chemicals are applied and the airport where the airplane takes off and lands. The present exemption for helicopters engaged in timber operations is expanded to include fixed-wing aircraft if such aircraft are not using the Federally funded airport and airway services.

Effective date.−The Senate amendment is effective for fuel use or air transportation after September 30, 2005.

Conference Agreement

The conference agreement follows the Senate amendment.

2. Modify the definition of rural airport (sec. 5222 of the Senate amendment and sec. 4261 of the Code)

Present Law

Air passenger transportation is subject to an excise tax equal to 7.5 percent of the amount paid plus $3.20 per domestic flight segment.[55] The $3.20 tax on flight segments does not apply to a domestic segment beginning or ending at a rural airport.

With respect to any calendar year, a rural airport is an airport that had fewer than 100,000 passengers departing by air during the second preceding calendar year for such airport and such airport either (1) is not located within 75 miles of a larger airport (one that had at least 100,000 passengers departing in the second preceding calendar year), or (2) was receiving essential air service subsidy payments as of August 5, 1997.

House Bill

No provision.

Senate Amendment

The Senate amendment expands the definition of qualified rural airport to include an airport that (1) is not connected by paved roads to another airport and (2) had fewer than 100,000 commercial passengers departing by air on flight segments of at least 100 miles during the second preceding calendar year.

Effective date.−The Senate amendment is effective on October 1, 2005.

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[55] Sec. 4261(a) and 4261(b).

Conference Agreement

The conference agreement follows the Senate amendment.

3. Exempt from ticket taxes transportation provided by seaplanes (sec. 5223 of the Senate amendment and secs. 4261 and 4083 of the Code)

Present Law

Air passenger transportation is subject to an excise tax equal to 7.5 percent of the amount paid plus $3.20 per domestic flight segment ("air passenger tax").[56] A 6.25-percent tax is imposed on amounts paid for transportation of property by air ("air cargo tax").[57] The air cargo tax applies only to amounts paid to persons engaged in the business of transporting property by air for hire. The air passenger tax and air cargo tax do not apply to amounts paid for the transportation if furnished on an aircraft having a maximum certificated takeoff weight of 6,000 pounds or less unless the aircraft is operated on an established line.[58]

House Bill

No provision.

Senate Amendment

The Senate amendment provides that the air passenger tax and the air cargo tax do not apply to transportation by a seaplane with respect to any segment consisting of a takeoff from, and a landing on, water, but only if the places at which such takeoff and landing occur have not received and are not receiving financial assistance from the Airport and Airway Trust Fund.

Effective date.−The Senate amendment is effective for transportation beginning after September 30, 2005.

Conference Agreement

The conference agreement follows the Senate amendment but clarifies that for purposes of the fuel taxes, transportation by seaplane is treated as noncommercial aviation.

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[56] Sec. 4261(a) and 4261(b).

[57] Sec. 4271.

[58] Sec. 4281.

4. Exempt certain sightseeing flights from taxes on air transportation (sec. 5224 of the Senate amendment and sec. 4281 of the Code)

Present Law

Under present law, taxable aviation transportation is subject to a 7.5-percent excise tax on the price of an airline ticket and a $3.20 segment tax. An exception to these taxes is provided for transportation by an aircraft having a maximum certificated takeoff weight of 6,000 pounds or less except when the aircraft is operated on an established line. Under the Treasury regulations to be "operated on an established line" means to be operated with "some degree of regularity between definite points. The term implies that the air carrier maintains control over the direction, routes, time, number of passengers carried, etc."[59] Treasury regulations provide that transportation need not be between two definite points to be taxable: a payment for continuous transportation beginning and ending at the same point is subject to the tax.[60] The IRS position is that the words "between definite points" do not require two separate points for purposes of determining whether an aircraft is operated on an established line. At least one court has agreed.[61]

House Bill

No provision.

Senate Amendment

For purposes of the exemption for small aircraft operated on nonestablished lines, an aircraft operated on a flight, the sole purpose of which is sightseeing, will not be considered as operated on an established line.

Effective date.−The Senate amendment is effective with respect to transportation beginning after September 30, 2005, but does not apply to any amount paid before such date for such transportation.

Conference Agreement

The conference agreement follows the Senate amendment.

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[59] Treas. Reg. sec. 49.4263-5(c).

[60] Treas. Reg. sec. 49.4261-1(c).

[61] *Lake Mead Air Inc. v. United States*, 991 F. Supp. 1209 (D. Nev. 1997) (the court determined that aircraft flights providing scenic tours of the Grand Canyon were operated on an established line).

D. Taxes Relating to Alcohol

1. Repeal special occupational taxes on producers and marketers of alcoholic beverages (sec. 5231 of the Senate amendment and secs. 5081, 5091, 5111, 5112, 5113, 5117, 5121, 5122, 5123, 5125, 5131, 5132, 5141, 5147, 5148, and 5276 of the Code)

Present Law

Under the law in effect prior to July 1, 2005, special occupational taxes are imposed on producers and others engaged in the marketing of distilled spirits, wine, and beer. These excise taxes are imposed as part of a broader Federal tax and regulatory structure governing the production and marketing of alcoholic beverages. The special occupational taxes are payable annually, on July 1 of each year. The tax rates in effect prior to July 1, 2005 are as follows:

Producers[62]:	
Distilled spirits and wines (sec. 5081)[63]	$1,000 per year, per premise
Brewers (sec. 5091)	$1,000 per year, per premise
Wholesale dealers (sec. 5111):	
Liquors, wines, or beer	$500 per year
Retail dealers (sec. 5121):	
Liquors, wines, or beer	$250 per year
Nonbeverage use of distilled spirits (sec. 5131):	$500 per year
Industrial use of distilled spirits (sec. 5276):	$250 per year

Section 246(a) of the American Jobs Creation Act of 2004 suspends the special occupational tax for the period beginning July 1, 2005 and ending June 30, 2008.[64]

Every person engaged in a trade or business on which a special occupational tax is imposed is required to register with the Secretary.[65] In addition, every dealer in liquors, wine or

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[62] A reduced rate of tax in the amount of $500.00 is imposed on small proprietors (as defined in the Code) (secs. 5081(b) and 5091(b)).

[63] Proprietors of plants producing distilled spirits exclusively for fuel use, with annual production not exceeding 10,000 proof gallons, are exempt. Secs. 5081(c) and 5181(c)(4).

[64] See sec. 5148.

[65] Secs. 5141 and 7011. The registration is of such person's name or style, place of residence, trade or business, and the place where such trade or business is to be carried on.

beer is required to keep records of their transactions.[66] A dealer is any person who sells, or offers for sale, distilled spirits, wine, or beer.[67] A delegate of the Secretary of the Treasury is authorized to inspect the records of any dealer during business hours.[68] There are penalties for failing to comply with the recordkeeping requirements.[69] There are also registration and regulation requirements for the nonbeverage use of distilled spirits, and permit and recordkeeping requirements for the industrial use of distilled spirits.[70]

The Code limits the persons from whom dealers may purchase their liquor stock intended for resale. A dealer may only purchase from:

1. a wholesale dealer in liquors who has paid the special occupational tax as such dealer to cover the place where such purchase is made; or

2. a wholesale dealer in liquors who is exempt, at the place where such purchase is made, from payment of such tax under any provision of chapter 51 of the Code; or

3. a person who is not required to pay special occupational tax as a wholesale dealer in liquors.[71]

Violation of this restriction in punishable by $1,000 fine, imprisonment of one year, or both.[72] A violation also subjects the alcohol to seizure and forfeiture.[73]

House Bill

No provision.

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[66] Secs. 5114 and 5124.

[67] Sec. 5112(a). Such definition includes producers and, in general, proprietors of warehouses.

[68] Sec. 5146.

[69] Sec. 5603.

[70] Secs. 5132 and 5275.

[71] Sec. 5117. For example, purchases from a proprietor of a distilled spirits plant at his principal business office would be covered under item (2) since such a proprietor is not subject to the special occupational tax on account of sales at his principal business office (sec. 5113(a)). Purchases from a State-operated liquor store would be covered under item (3) (sec. 5113(b)).

[72] Sec. 5687.

[73] Sec. 7302.

Senate Amendment

The Senate amendment repeals the special occupational taxes on producers and marketers of alcoholic beverages and on the nonbeverage or industrial use of distilled spirits. The registration, recordkeeping and inspection rules applicable to wholesale and retail dealers are retained.[74] For purposes of the recordkeeping requirements for wholesale and retail liquor dealers, the Senate amendment provides a rebuttable presumption that a person who sells, or offers for sale, distilled spirits, wine, or beer, in quantities of 20 wine gallons or more to the same person at the same time is engaged in the business of a wholesale dealer in liquors or a wholesale dealer in beer. In addition, the Senate amendment retains the present-law rules that make it unlawful for any liquor dealer to purchase distilled spirits for resale from any person other than a wholesale liquor dealer subject to the recordkeeping requirements, or a proprietor of a distilled spirits plant subject to recordkeeping requirements.[75] Existing general criminal penalties relating to records and reports apply to wholesalers and retailers who fail to comply with these requirements.

Effective date.−The Senate amendment is effective on July 1, 2008. The provision does not affect liability for taxes imposed with respect to periods before July 1, 2008.

Conference Agreement

The conference agreement follows the Senate amendment.

2. Modify limitation on rate of rum excise tax cover over to Puerto Rico and Virgin Islands (sec. 5232 of the Senate amendment)

Present Law

A $13.50 per proof gallon[76] excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States.[77] The excise tax does not apply to distilled spirits

[74] The provision also retains the present-law registration and regulation requirements for the nonbeverage use of distilled spirits, and the permit and recordkeeping requirements for the industrial use of distilled spirits.

[75] Proprietors of distilled spirits plants remain subject to present law recordkeeping requirements under section 5207. Under present law, a limited retail dealer in liquors (such as a charitable organization selling liquor at a picnic) may lawfully purchase distilled spirits for resale from a retail dealer in distilled spirits. The provision retains this rule.

[76] A proof gallon is a liquid gallon consisting of 50 percent alcohol. See sec. 5002(a)(10) and 5002(a)(11).

[77] Sec. 5001(a)(1).

that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).[78]

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.[79] The amount of the cover over is limited under Code section 7652(f) to $10.50 per proof gallon ($13.25 per proof gallon during the period July 1, 1999 through December 31, 2005).

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.[80] Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.[81] All of the amounts covered over are subject to the limitation.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, the cover over amount of $13.25 per proof gallon is modified to $13.50 for rum brought into the United States after December 31, 2005 and before January 1, 2007. After December 31, 2006, the cover over amount reverts to $10.50 per proof gallon.

The Senate amendment additionally requires that Puerto Rico transfers a portion of the amount covered over to Puerto Rico to the Puerto Rico Conservation Trust Fund (the "Fund").[82] The treasury of Puerto Rico is required to transfer to the Fund amounts equal to 50 cents per proof gallon of the taxes covered over to Puerto Rico, and attributable to rum imported into the

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[78] Secs. 5062(b), 7653(b), and 7653(c).

[79] Secs. 7652(a)(3), 7652(b)(3), and 7652(e)(1). One percent of the amount of excise tax collected from imports into the United States of articles produced in the Virgin Islands is retained by the United States under section 7652(b)(3).

[80] Sec. 7652(e)(2).

[81] Secs. 7652(a)(3), (b)(3), and 7652(e)(1).

[82] The Puerto Rico Conservation Trust Fund was established pursuant to a Memorandum of Understanding, dated December 24, 1968, between the United States Department of the Interior and the Commonwealth of Puerto Rico.

United States that was produced neither in Puerto Rico nor the Virgin Islands. The transfers are required to be made within 30 days of each such cover over payment to Puerto Rico. Each transfer payment is to be treated as principal for an endowment, the income from which is to be used by the Fund for the purposes for which the Fund was established. If Puerto Rico fails to make a timely payment to the Trust Fund, the Secretary of the Treasury shall deduct and withhold such unpaid amount from the next cover over payment, plus interest, and shall transfer such amounts directly to the Fund. Such deduction, withholding, and direct payment will not be made if the Secretary of the Interior, after consultation with the Governor of Puerto Rico, finds that the failure of the treasury of Puerto Rico to make the transfer payment was for good cause. The transfer requirement expires after December 31, 2006.

Effective date.−The change in the cover over rate is effective for articles brought into the United States after December 31, 2005. The Senate amendment regarding the Puerto Rico Conservation Trust Fund is effective January 1, 2006.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Provide an income tax credit for cost of carrying tax-paid distilled spirits in wholesale inventories and in control State bailment warehouses (sec. 5233 of the Senate amendment and new sec. 5011 of the Code)

Present Law

As is true of most major Federal excise taxes, the excise tax on distilled spirits is imposed at a point in the chain of distribution before the product reaches the retail (consumer) level. The excise tax on distilled spirits produced in the United States is imposed when the distilled spirits are removed from the distilled spirits plant where they are produced. Distilled spirits that are bottled before importation into the United States are taxed on removal from the first U.S. customs bonded warehouse to which they are landed (including a warehouse located in a foreign trade zone). Distilled spirits imported in bulk containers for bottling in the United States may be transferred to a domestic distilled spirits plant without payment of tax; subsequently, these distilled spirits are taxed in the same way as domestically produced distilled spirits.

No tax credits are allowed under present law for business costs associated with having tax-paid products in inventory. Rather, excise tax that is included in the purchase price of a product is treated the same as the other components of the product cost, i.e., deductible as a cost of goods sold.

House Bill

No provision.

Senate Amendment

The Senate amendment creates a new income tax credit for eligible wholesalers, distillers, and importers, of distilled spirits. The credit is in addition to present-law rules

allowing tax included in inventory costs to be deducted as a cost of goods sold, and is treated as part of the general business credits.

The credit is calculated by multiplying the number of cases of bottled distilled spirits by the average tax-financing cost per case for the most recent calendar year ending before the beginning of such taxable year. A case is 12 80-proof 750-milliliter bottles. The average tax-financing cost per case is the amount of interest that would accrue at corporate overpayment rates during an assumed 60-day holding period on an assumed tax rate of $25.68 per case of 12 80-proof 750-milliliter bottles.

The wholesaler credit only applies to domestically bottled distilled spirits[83] purchased directly from the bottler of such spirits. An eligible wholesaler is any person that holds a permit under the Federal Alcohol Administration Act as a wholesaler of distilled spirits that is not a State, or agency or political subdivision thereof.

For distillers and importers that are not eligible wholesalers, the credit is limited to bottled inventory in a warehouse owned and operated by, or on behalf of, a State or political subdivision thereof, when title to such inventory has not passed unconditionally. The credit for distillers and importers applies to distilled spirits bottled both domestically and abroad.

Effective date.−The Senate amendment is effective for taxable years beginning after September 30, 2005.

Conference Agreement

The conference agreement follows the Senate amendment.

4. Quarterly excise tax filing for small alcohol excise taxpayers (sec. 5234 of the Senate amendment and sec. 5061 of the Code)

Present Law

In general, excise taxes on distilled spirits, wines, and beers are collected on the basis of returns filed in accordance with rules prescribed by the Secretary of the Treasury.[84] In the case of distilled spirits, beer, and wine withdrawn under bond for deferred payment of tax ("deferred payment bond"), domestic producers are generally required to pay alcohol excise taxes within 14 days after the last day of the semi-monthly period during which the article is withdrawn.[85] In the case of distilled spirits, wines, and beer which are imported into the United States (other than in bulk containers), the importer is generally required to pay alcohol excise taxes within 14 days

[83] Distilled spirits that are imported in bulk and then bottled domestically qualify as domestically bottled distilled spirits.

[84] Sec. 5061(a).

[85] Sec. 5061(d)(1).

after the last day of the semi-monthly period during which the article is entered into the customs territory of the United States.[86] In the case of imported articles entered for warehousing, the taxes are generally due within 14 days after the last day of the semi-monthly period during which the article is removed from the first such warehouse.[87] Treasury regulations also permit certain very small wine producers to file and pay on an annual basis.[88]

Special rules apply to accelerate payments made with respect to taxes allocable to the second half of the month of September.[89]

House Bill

No provision.

Senate Amendment

Under the Senate amendment, domestic producers and importers of distilled spirits, wine, and beer with excise tax liability of $50,000 or less attributable to such articles in the preceding calendar year may file returns and pay taxes within 14 days after the end of the calendar quarter instead of semi-monthly. In order to qualify, the taxpayer's liability for such taxes during the immediately preceding year must have been $50,000 or less, and, as of the beginning of the current calendar year, the taxpayer must reasonably expect to pay less than $50,000 in such taxes for that year. The Senate amendment does not apply to a taxpayer for any portion of the calendar year following the first date on which the aggregate amount of tax due for that year exceeds the $50,000 threshold.

The special rules accelerating payments for taxes allocable to the second half of September do not apply to quarterly filers under the Senate amendment.

Very small wine producers who have not given deferred payment bonds may still file and pay on an annual basis as under present law.

Effective date.−The Senate amendment is effective for quarterly periods beginning on and after January 1, 2006.

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[86] Sec. 5061(d)(2)(A).

[87] Sec. 5061(d)(2)(B).

[88] Annual filing and payment is permitted to a wine producer who has not given a deferred payment bond, and who either paid wine excise taxes in an amount less than $1,000 during the previous calendar year or is a proprietor of a new bonded wine premise and expects to pay less than $1,000 in wine excise taxes before the end of the calendar year. 27 CFR sec. 24.273(a).

[89] Sec. 5061(d)(4).

Conference Agreement

The conference agreement follows the Senate amendment with the clarification that quarterly filing and payment applies only to withdrawals, removals, and entries (and articles brought into the United States from Puerto Rico) under deferred payment bonds. Transactions that are not made under deferred payment bonds do not qualify for quarterly filing and payment, but do count toward determining whether the $50,000 threshold has been reached.

E. Sport Excise Taxes

1. Custom gunsmiths (sec. 5241 of the Senate amendment and sec. 4182 of the Code)

Present Law

The Code imposes an excise tax upon the sale by the manufacturer, producer or importer of certain firearms and ammunition.[90] Pistols and revolvers are taxable at 10 percent. Firearms (other than pistols and revolvers), shells, and cartridges are taxable at 11 percent. The excise tax for firearms imposed on manufacturers, producers, and importers does not apply to machine guns and short barreled firearms. Sales to the Defense Department of firearms, pistols, revolvers, shells and cartridges also are exempt from the tax.

House Bill

No provision.

Senate Amendment

The Senate amendment exempts from the firearms excise tax firearms, pistols, and revolvers manufactured, produced, or imported by a person who manufactures, produces, and imports less than 50 of such articles during the calendar year. Controlled groups are treated as a single person for determining the 50-article limit.

Effective date.−The Senate amendment is effective for articles sold by the manufacturer, producer, or importer after September 30, 2005. No inference is intended from the prospective effective date of this provision as to the proper treatment of pre-effective date sales.

Conference Agreement

The conference agreement follows the Senate amendment.

[90] Sec. 4181.

III. MISCELLANEOUS PROVISIONS

A. Motor Fuel Tax Enforcement Advisory Commission (sec. 5301 of the Senate amendment)

Present Law

Present law does not require that there be an advisory commission on motor tax fuel enforcement.

House Bill

No provision.

Senate Amendment

The Senate amendment establishes a "Motor Fuel Tax Enforcement Advisory Commission" (the "Commission"). The purpose of the Commission is to: (1) review motor fuel revenue collections, historical and current; (2) review the progress of investigations; (3) develop and review legislative proposals with respect to motor fuel taxes; (4) monitor the progress of administrative regulation projects relating to fuel taxes; (5) review the results Federal and State agency cooperative efforts regarding motor fuel taxes; and (6) review the results of Federal interagency cooperative efforts regarding motor fuel taxes. The Commission also is to evaluate and make recommendations regarding: (1) the effectiveness of existing Federal enforcement programs regarding motor fuel taxes; (2) enforcement personnel allocation; and (3) proposals for regulatory projects, legislation, and funding.

The Commission is to be composed of the following:

1. At least one representative from each of the following Federal entities: the Department of Homeland Security, the Department of Transportation - Office of Inspector General, the Federal Highway Administration, the Department of Defense, and the Department of Justice;

2. At least one representative from the Federation of State Tax Administrators;

3. At least one representative from any State Department of Transportation;

4. Two representatives from the highway construction industry;

5. Six representatives from industries relating to fuel distribution: refiners (two representatives), distributors (one representative), pipelines (one representative), terminal operators (two representatives);

6. One representative from the retail fuel industry; and

7. Two representatives each from the staff of the Senate Committee on Finance and the House Committee on Ways and Means.

Members of the Commission are to be appointed by the Chairmen and Ranking Members of the Senate Committee on Finance and the House Committee on Ways and Means. Representatives from the Department of Treasury and the IRS shall be available to consult with the Commission upon request. The Commission is to terminate after September 30, 2009.

Effective date.−The Senate amendment is effective on the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

B. National Surface Transportation Infrastructure Financing Commission (sec. 5302 of the Senate amendment)

Present Law

Present law does not provide for any advisory commissions related Federal highway or mass transit funding.

House Bill

No provision.

Senate Amendment

The provision establishes a "National Surface Transportation Infrastructure Financing Commission" (the "Financing Commission"). The Financing Commission is to be composed of 15 members drawn from among individuals knowledgeable in the fields of public transportation finance or highway and transit programs, policy, and needs. Financing Commission members may include representatives of State and local governments or other public transportation agencies, representatives of the transportation construction industry, providers of transportation, persons knowledgeable in finance, and users of highway and transit systems.

The Financing Commission will make an investigation and study of revenues flowing into the Highway Trust Fund under present law. The Financing Commission will consider whether the amount of such revenues is likely to increase, decline or remain unchanged absent changes in the law. The Financing Commission will consider alternative approaches to generating revenues for the Highway Trust Fund, and the level of revenues that such alternatives would yield. The Financing Commission will consider highway and transit needs and whether additional revenues into the Highway Trust Fund, or other Federal revenues dedicated to highway and transit infrastructure, would be required in order to meet such needs.

The Financing Commission will develop a final report, with recommendations and the bases for those recommendations. The Financing Commission's recommendations will address: (1) what levels of revenue are required by the Highway Trust Fund in order for it to meet needs to maintain and improve the condition and performance of the nation's highway and transit systems; (2) what levels of revenue are required by the Highway Trust Fund in order to ensure that Federal levels of investment in highways and transit do not decline in real terms; and (3) the extent, if any, to which the Highway Trust Fund should be augmented by other mechanisms or funds as a Federal means of financing highway and transit infrastructure investments.

The Financing Commission will submit its report and recommendations within two years of the date of its first meeting to the Secretary of Transportation, the Secretary of the Treasury, the House Committee on Ways and Means, Senate Committee on Finance, the House Committee on Transportation and Infrastructure, the Senate Committee on Environment and Public Works, and Senate Committee on Banking, Housing, and Urban Affairs.

Effective date.−The Senate amendment is effective on the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment with the following modification. The Commission also must consider a program that would exempt all or a portion of gasoline or other motor fuels used in a State from the Federal excise tax on such gasoline or other motor fuels if such State elects not to receive all or a portion of Federal transportation funding, including: (1) whether such State should be required to increase State gasoline or other motor fuels taxes by the amount of the decrease in the Federal excise tax on such gasoline or other motor fuels; (2) whether any Federal transportation funding should not be reduced or eliminated for States participating in such program; (3) whether there are any compliance problems related to enforcement of Federal transportation-related excise taxes; and (4) study such other matters closely related to the subjects described in the preceding subparagraphs as it may deem appropriate.

C. Expand Highway Trust Fund Expenditure Purposes to Include Funding for Studies of Supplemental or Alternative Financing for the Highway Trust Fund (sec. 5303 of the Senate amendment)

Present Law

In general

Dedication of excise tax revenues to the Highway Trust Fund and expenditures from the Highway Trust Fund are governed by provisions of the Code (sec. 9503).[91] The Code authorizes expenditures (subject to appropriations) from the Fund through July 27, 2005, for the purposes provided in authorizing legislation, as in effect on the date of enactment of the Surface Transportation Extension Act of 2005, Part IV.

The Highway Trust Fund has a subaccount for Mass Transit. Both the Trust Fund and its subaccount are funding sources for specific programs.

Highway Trust Fund expenditure purposes have been revised with each authorization Act enacted since establishment of the Highway Trust Fund in 1956. In general, expenditures authorized under those Acts (as the Acts were in effect on the date of enactment of the most recent such authorizing Act) are approved by the Code as Highway Trust Fund expenditure purposes.[92]

Highway Trust Fund expenditure purposes

Highway Trust Fund expenditure purposes

The Highway Trust Fund receives revenues from all non-fuel highway transportation excise taxes and revenues from all but 2.86 cents per gallon of the highway motor fuels excise taxes transferred to the Highway Trust Fund. Programs financed from the Highway Trust Fund (excluding the Mass Transit account) include:

1. Interstate maintenance program;

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[91] The Highway Trust Fund statutory provisions were placed in the Internal Revenue Code in 1982.

[92] The authorizing Acts which currently are referenced in the Highway Trust Fund provisions of the Code are: the Highway Revenue Act of 1956; Titles I and II of the Surface Transportation Assistance Act of 1982; the Surface Transportation and Uniform Relocation Act of 1987; the Intermodal Surface Transportation Efficiency Act of 1991; the Transportation Equity Act for the 21st Century; the Surface Transportation Extension Act of 2003; the Surface Transportation Extension Act of 2004; the Surface Transportation Extension Act of 2004 Part II; the Surface Transportation Extension Act of 2004, Part III; the Surface Transportation Extension Act of 2004, Part IV; the Surface Transportation Extension Act of 2004, Part V; the Surface Transportation Extension Act of 2005; the Surface Transportation Extension Act of 2005, Part II; the Surface Transportation Extension Act of 2005, Part III; and the Surface Transportation Extension Act of 2005, Part IV.

2. National Highway System;

3. The bridge program (bridge replacement and repair);

4. Surface transportation programs;

5. Congestion mitigation and air quality improvement program;

6. Highway safety programs and research and development, including a share of the cost of National Highway Traffic Safety Administration ("NHTSA") programs and university research centers;

7. Appalachian development highway system program;

8. Recreational trails program;

9. Federal lands highways program;

10. National corridor planning and development and coordinated border infrastructure programs;

11. Construction of ferry boats and ferry terminal facilities;

12. National scenic byways program;

13. Value pricing pilot program;

14. High priority projects program;

15. Highway use tax evasion projects; and

16. Commonwealth of Puerto Rico highway program.

Certain administrative costs of the Federal Highway Administration and NHTSA are also funded from the Highway Trust Fund.

Mass Transit Account expenditure purposes

The Highway Fund's Mass Transit Account receives revenues equivalent to 2.86 cents per gallon of the highway motor fuels excise taxes. Mass Transit Account monies are available through July 27, 2005, for capital and capital-related expenditures under section 5338(a)(1) and 5338(b)(1) of Title 49, United States Code; the Intermodal Surface Transportation Efficiency Act of 1991; the Transportation Equity Act for the 21st Century; the Surface Transportation Extension Act of 2003; the Surface Transportation Extension Act of 2004; the Surface Transportation Extension Act of 2004, Part II; the Surface Transportation Extension Act of 2004, Part III; the Surface Transportation Extension Act of 2004, Part IV; and the Surface Transportation Extension Act of 2004, Part V; as those provisions were in effect on the date of enactment of the Surface Transportation Extension Act of 2004, Part V; the Surface Transportation Extension Act of 2005; the Surface Transportation Extension Act of 2005, Part II;

the Surface Transportation Extension Act of 2005, Part III; and the Surface Transportation Extension Act of 2005, Part IV.

House Bill

No provision.

Senate Amendment

The Senate amendment expands the expenditure authority and authorizes the expenditure of monies from the Highway Trust Fund to fund two comprehensive studies of supplemental or alternative funding sources for the Highway Trust Fund. One study, to receive $1 million in funding, will review funding mechanisms of other industrialized nations and examine the viability of proposals such as congestion pricing, greater reliance on tolls, privatization of facilities, and other funding proposals. This study would be due no later than December 31, 2006. The other study, to receive $16.5 million in funding, would report on a long-term field test of a new approach to assessing highway use taxes by use of an on-board computer that links to satellites to calculate road mileage traversed and compute the appropriate highway use tax for each of the Federal, State, and local government as the vehicle makes use of the roads. The results of this study would be due no later than December 31, 2011. Each study would be delivered to the Secretary of the Treasury and the Secretary of Transportation.

Effective date.−The Senate amendment is effective upon date of enactment.

Conference Agreement

The conference agreement addresses authorization of expenditures for the study of alternative financing for the Highway Trust Fund elsewhere in the conference agreement and does not amend the Code for this purpose.

D. Delta Regional Transportation Plan
(sec. 1806 of the House bill and sec. 5304 of the Senate amendment)

Present Law

The Delta Regional Authority is a Federal-State partnership, serving a 240-county/parish area in an eight-State region.[93] No State is required to participate with the authority. The duties of the authority are to: (1) produce a regional development plan; (2) set priorities for approval of grants in the region; (3) assess the region's needs and assets; (4) inform participating States about interstate cooperation; (5) work with States and local agencies to develop model legislation; (6) enhance the capacity of and support Local Development Districts, as well as the creation of Local Development Districts where none currently exist; (7) encourage private investment in economic development projects in the region; and (8) assist State governments with the States' economic development program.

House Bill

The provision directs Secretary of Transportation to enter into an agreement with the Delta Regional Authority to conduct a comprehensive study of transportation assets and needs in the eight states comprising the Delta region (Alabama, Arkansas, Illinois, Kentucky, Louisiana, Mississippi, Missouri, and Tennessee). The agreement must be entered into within six months from the date of enactment. The study and recommendations must be submitted, no later than 24 months after the date of entry into the agreement, to the Secretary of Transportation, to the Committee on Transportation and Infrastructure of the House of Representatives and the Committee on Environment and Public Works of the Senate.

The study is to include all modes of transportation (including passenger and freight transportation). The Delta Regional Authority is to work with local planning and development districts, local and regional governments, metropolitan planning organizations, State transportation entities, and Department of Transportation to develop a regional strategic transportation plan. Upon completion of the study, the Delta Regional Authority is to create a regional strategic plan to achieve efficient transportation systems in the Delta region.

The provision authorizes the Delta Regional Authority to receive $500,000 in fiscal year 2005, and $500,000 in fiscal year 2006 to conduct a comprehensive study and plan. These funds are to remain available until spent.

Effective date.−The House bill is effective on the date of enactment.

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[93] The covered States and counties are: Alabama - 20 counties; Arkansas - 42 counties; Illinois, 16 counties; Kentucky - 21 counties; Louisiana - 46 parishes; Mississippi - 45 counties; Missouri - 29 counties; and Tennessee - 21 counties. Delta Regional Authority, *Legislative Matters and Overview* (February 1, 2004),< www.dra.gov/legislation.php >.

Senate Amendment

The Senate amendment generally follows the House bill but does not require an agreement with the Secretary of Transportation, nor does it set a deadline for the submission of the report.

Effective date.−The Senate amendment is effective on the date of enactment.

Conference Agreement

The conference agreement addresses the Delta Region Transportation Plan elsewhere in the conference agreement and does not amend the Code for this purpose.

E. Establish Build America Corporation (sec. 5305 of the Senate amendment)

Present Law

There is no provision in Federal law establishing a nonprofit corporation dedicated to providing financing or other financial support for transportation infrastructure projects.

House Bill

No provision.

Senate Amendment

The Senate amendment establishes a nonprofit corporation, to be known as the "Build America Corporation." The Build America Corporation is not an agency or establishment of the United States Government. The Build America Corporation generally shall be subject to the laws of the State of Delaware applicable to non-profit corporations.

The purpose of the corporation is to provide financial support for qualified projects. Under the provision, a "qualified project" generally is defined as any transportation infrastructure project of any governmental unit or other person that is proposed by a State, including a highway project, a transit system project, a railroad project, an airport project, a port project, and an inland waterways project. The provision imposes additional requirements if a qualified project is financed by debt issued by the Build America Corporation.

Effective date.−The Senate amendment is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

F. Increase in Dollar Limits for Qualified Transportation Fringe Benefits (sec. 5306 of the Senate amendment)

Present Law

Under present law, qualified transportation benefits are excludable from gross income and wages for employment tax purposes. Qualified transportation benefits are: (1) transportation in a commuter highway vehicle if such transportation is in connection with travel between the employee's residence and place of employment ("van pooling"); (2) transit passes; and (3) qualified parking. For purposes of the exclusion for van pooling benefits, a commuter highway vehicle is any highway vehicle: (1) the seating capacity of which is at least six adults (excluding the driver); and (2) at least 80 percent of the mileage use of which can reasonably be expected to be (a) for purposes of transporting employees in connection with travel between their residences and their place of employment and (b) on trips during which the number of employees transported for such purposes is at least one-half of the adult seating capacity of such vehicle (not including the driver).

The maximum amount of qualified parking that is excludable from income and wages is $200 per month (for 2005). The maximum amount of transit passes and van pooling benefits that are excludable from income and wages per month is $105 (for 2005). These dollar amounts are indexed for inflation.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, the maximum dollar amount of excludable van pooling and transit pass benefits is increased to $155 per month. The maximum amount of excludable qualified parking is $200 per month. The dollar amounts are indexed for inflation after 2008 (with 2007 as a base year). Beginning in 2010, the maximum dollar amount of excludable van pooling and transit pass benefits is increased so that it is equal to the maximum amount of excludable qualified parking.

Effective date.–The Senate amendment is effective for taxable years beginning after December 31, 2005.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

G. Treasury Study of Highway Fuels Used by Trucks for Non-Transportation Purposes (sec. 5307 of the Senate amendment)

Present Law

Present law does not provide for a study of the fuel use by trucks.

House Bill

No provision.

Senate Amendment

The Senate amendment directs the Secretary of the Treasury to study the use by trucks of highway motor fuel that is not used for the propulsion of the vehicle, both in the case of vehicles carrying equipment that is unrelated to the transportation function of the vehicle and in the case where non-transportation equipment is run by a separate motor. In addition, the Secretary is to estimate the amount of fuel consumed and pollutants emitted by trucks due to the long-term idling of diesel engines, and report on the cost of reducing long-term idling through various technologies. The Secretary is to propose options for implementing exemptions for classes of vehicles whose nonpropulsive fuel use exceeds 50 percent.

Effective date.−The Senate amendment is effective on the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment with modification that the Secretary is to propose options for implementing exemptions from tax for fuel used in non-transportation uses, but only if the Secretary determines such exemptions are administratively feasible, for the following: (1) mobile machinery whose nonpropulsive fuel use exceeds 50 percent and (2) any highway vehicle that consumes fuel for both transportation- and non-transportation-related equipment, using a single motor. With respect to item (2), it is intended that the Secretary take into consideration such factors as whether the fuel use for non-transportation equipment by the vehicle operator is significant both relative to transportation-related fuel consumption of the vehicle and relative to the vehicle operator's business. There may be significant non-transportation use of taxed fuel even if such use is small relative to the vehicle's transportation use, if the vehicle is used extensively. Also with respect to item (2), it is intended that the Secretary take into account variations in fuel use among the different types of vehicles, such as concrete mixers, refuse collection vehicles, tow trucks, mobile drills, and other vehicles that the Secretary identifies.

H. Tax-Exempt Financing of Highway Projects and Rail-Truck Transfer Facilities (sec. 5308 of the Senate amendment and sec. 142 of the Code)

Present law

Tax-exempt bonds

In general

Interest on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Interest on State or local bonds to finance activities of private persons ("private activity bonds") is taxable unless a specific exception is contained in the Code (or in a non-Code provision of a revenue Act). The term "private person" generally includes the Federal government and all other individuals and entities other than States or local governments.

Qualified private activity bonds

Private activity bonds are eligible for tax-exemption if issued for certain purposes permitted by the Code ("qualified private activity bonds"). The definition of a qualified private activity bond includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond.[94] The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); low-income residential rental property; privately owned and/or operated utility facilities (sewage, water, solid waste disposal, and local district heating and cooling facilities, certain private electric and gas facilities, and hydroelectric dam enhancements); public/private educational facilities; and, qualified green building/sustainable design projects.[95]

Issuance of most qualified private activity bonds is subject (in whole or in part) to annual State volume limitations.[96] Exceptions are provided for bonds for certain governmentally owned facilities (airports, ports, high-speed intercity rail, and solid waste disposal) and bonds which are subject to separate local, State, or national volume limits (public/private educational facilities, enterprise zone facility bonds, and qualified green building/sustainable design projects).

House Bill

No provision.

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[94] Sec. 141(e).

[95] Sec. 142(a).

[96] Sec. 146.

Senate Amendment

The Senate amendment establishes new categories of exempt facility bonds: bonds issued to finance "qualified highway facilities" and bonds issued to finance "qualified surface freight transfer facilities" (collectively "qualified highway or surface freight transfer facilities"). Under the provision, a qualified highway facility is any surface transportation or international bridge or tunnel project (for which an international entity authorized under Federal or State law is responsible) which receives Federal assistance under title 23 of the United States Code (relating to Highways). A qualified surface freight transfer facility is a facility for the transfer of freight from truck to rail or rail to truck which receives Federal assistance under title 23 or title 49 of the United States Code (relating to Transportation).

Under the provision, bonds issued to finance qualified highway or surface freight transfer facilities are not subject to the State volume limitations. Rather, there is an annual limitation on the aggregate amount of bonds that may be issued to finance such facilities for each of the calendar years 2005 through 2015, as follows: $130 million for 2005; $750 million for each of the years 2006, 2007, 2008, and 2009; $1.87 billion for 2010; $2 billion for each of the years 2011, 2012, 2013, 2014, and 2015. The Secretary of Transportation may allocate the annual bond authority among qualified highway or surface freight transfer facilities in such manner as the Secretary of Transportation determines appropriate. The authority to issue qualified highway or surface freight transfer facility bonds terminates after December 31, 2015.

The Senate amendment requires the proceeds of qualified highway or surface freight transfer facility bonds to be spent on qualified projects within five years from the date of issuance of such bonds. Proceeds that remain unspent after five years must be used to redeem outstanding bonds. However, the provision authorizes the Secretary of the Treasury (or his delegate) to extend the five-year period if the issuer establishes that the need for the extension is appropriate and due to circumstances not within the control of the issuer.

Effective date.−The Senate amendment applies to bonds issued after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment provision with modifications. The conference agreement eliminates the limitation on the aggregate amount of qualified highway or surface freight transfer facility bonds that may be issued in each of the calendar years 2005 through 2015. The Secretary of Transportation is authorized to allocate a total of $15 billion of issuance authority to qualified highway or surface freight transfer facilities in such manner as the Secretary determines appropriate. The conference agreement also clarifies that bonds are not treated as qualified highway or surface freight transfer facility bonds unless the aggregate amount of bonds issued with respect to qualified facilities does not exceed the amount of authority allocated to such facilities by the Secretary of Transportation. However, the aggregate limitation on bonds that may be issued does not apply to the "current refunding" of qualified highway or surface freight transfer facility bonds. Bonds are treated as a current refunding for this purpose if: (1) the average maturity date of the refunding bond is not later than the average maturity date of the refunded bonds; (2) the amount of the refunding bond does not

exceed the outstanding amount of the refunded bond, and (3) the refunded bond is redeemed not later than 90 days after the date of the issuance of the refunding bond.

The conference agreement on this provision is not intended to expand the scope of any Federal requirement beyond its application under present law and does not broaden the application of any Federal requirement under present law in Title 49.

I. Tax Treatment of State Ownership of Railroad Real Estate Investment Trust (sec. 5309 of the Senate amendment and secs. 103, 115, 336, and 337 of the Code)

Present Law

A real estate investment trust ("REIT") is an electing entity that is engaged primarily in passive real estate activities (as specifically defined) and that, among other requirements, must have at least 100 shareholders. If a qualified entity elects REIT status, it can pay little or no corporate level tax, since a REIT is allowed a deduction for amounts distributed to its shareholders and is required to distribute at least 90 percent of its income to shareholders annually.

If an entity does not qualify to be treated as a REIT, it would generally be treated as a regular corporation subject to corporate level tax on its income under subchapter C and section 11 of the Code. Such a corporation can elect to be taxed as a partnership or disregarded entity under Treasury regulations. However, if it made such an election, the corporation would be treated as if it had liquidated and distributed its assets to shareholders, generally resulting in corporate-level tax on the excess of the fair market value over the basis of corporate assets.[97] A corporation that itself becomes a tax-exempt entity also must pay corporate tax on the excess of the fair market value over the basis of its assets.[98]

A State or local government is not subject to Federal income tax on income that accrues to the State or any political subdivision thereof and that is derived from any public utility or the exercise of any activity that is an essential governmental function.[99]

Interest on a State and local bond is excluded from gross income, with certain exceptions.[100] Special rules are also provided as requirements for tax exemption for State and local bonds.[101] State and local bonds can be classified by the type of entity using the proceeds as either governmental or private activity bonds. In general, bonds are governmental bonds if the proceeds of the bonds are used to finance direct activities of governmental entities or if the bonds are repaid with revenues of governmental entities. Private activity bonds are bonds with respect to which a State or local government serves as a conduit providing financing to private businesses or individuals. The exclusion from income for State and local bonds does not apply to private activity bonds unless the bonds are issued for certain purposes permitted by the Code.

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[97] Sec. 336. An exception to this gain recognition applies to certain liquidations into a corporation that owns 80 percent of the liquidating entity and that is not itself tax-exempt. Sec. 337.

[98] Treas. Reg. sec. 1.337(d)-4(a)(2).

[99] Sec. 115.

[100] Sec. 103.

[101] Secs. 141-150.

In addition, both governmental and private activity bonds must satisfy applicable rules provided for in the Code as a condition of tax exemption. [102]

House Bill

No provision.

Senate Amendment

Under the Senate amendment, the income of a qualified corporation that is derived from its railroad transportation and economic development activities, that constitute substantially all of its activities (as described below), is treated as accruing to the State for purposes of section 115, to the extent such activities are of a type which are an essential governmental function under section 115 of present law. For purposes of the provision, a qualified corporation is a corporation which is a REIT on the date of enactment and which is a non-operating Class III railroad that becomes 100 percent owned by a State after December 31, 2003 and before December 31, 2006. Moreover, substantially all activities of the corporation must consist of the ownership, leasing, and operation by such corporation of facilities, equipment, and other property used by the corporation or other persons for railroad transportation and for economic development for the benefit of the State and its citizens.

Under the Senate amendment, no gain or loss shall be recognized from the deemed conversion of such a REIT to such a qualified corporation and no change in the basis of the property of the entity shall occur.

Also, any obligation issued by a qualified corporation described above is treated as an obligation of a State for purposes of applying the tax exempt bond provisions if 95 percent of the net proceeds of such obligation are to be used to provide for the acquisition, construction, or improvement of railroad transportation infrastructure (including railroad terminal facilities). In addition, such an obligation shall not be treated as a private activity bond solely by reason of the ownership or use of such railroad transportation infrastructure by the corporation. All other present-law provisions relating to tax exempt bonds continue to apply to and govern bonds issued by the corporation. For example, the use by a private business of railroad property financed with the proceeds of bonds issued by a qualified corporation may cause such bonds to be taxable private activity bonds.

Effective date.–The Senate amendment applies on and after the date a State becomes the owner of all the outstanding stock of a qualified corporation through action of such corporation's board of directors, provided that the State becomes the owner of all the voting stock of the corporation on or before December 31, 2003 and becomes the owner of all the outstanding stock of the corporation on or before December 31, 2006.

[102] Secs. 141-150.

Conference Agreement

The conference agreement follows the Senate amendment.

J. Incentives for Installation of Alternative Fuel Refueling Property (secs. 5310 and 2010 of Senate amendment)

Present Law

Certain costs of qualified clean-fuel vehicle refueling property may be expensed and deducted when such property is placed in service (sec. 179A). Up to $100,000 of such property at each location owned by the taxpayer may be expensed with respect to that location. Natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which is methanol, ethanol, or any other alcohol or ether comprise clean-burning fuels.

The deduction is unavailable for property placed in service after December 31, 2006.

House Bill

No provision.

Senate Amendment

The Senate amendment provision permits taxpayers to claim a 50-percent credit for the cost of installing clean-fuel vehicle refueling property to be used in a trade or business of the taxpayer or installed at the principal residence of the taxpayer. In the case of retail clean-fuel vehicle refueling property installed as part of the taxpayer's business the allowable credit may not exceed $30,000. In the case of residential clean-fuel vehicle refueling property the allowable credit may not exceed $1,000.

Under the provision clean fuels are any fuel at least 85 percent of the volume of which consists of ethanol, natural gas, compressed natural gas, liquefied natural gas, and hydrogen.

The taxpayer's basis in the property is reduced by the amount of the credit and the taxpayer may not claim deductions under section 179A with respect to property for which the credit is claimed. In the case of refueling property installed on property owned or used by a tax-exempt person, the taxpayer that installs the property may claim the credit. To be eligible for the credit, the property must be placed in service before January 1, 2010. The credit allowable in the taxable year cannot exceed the difference between the taxpayer's regular tax (reduced by certain other credits) and the taxpayer's tentative minimum tax. The taxpayer may carry forward unused credits for 20 years.

Effective date.–The Senate amendment is effective for property placed in service after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

K. Modify Recapture of Section 197 Amortization (sec. 5311 of the Senate amendment)

Present Law

Taxpayers are entitled to recover the cost of amortizable section 197 intangibles using the straight-line method of amortization over a uniform life of fifteen years.[103] With certain exceptions, amortizable section 197 intangibles generally are purchased intangibles held by a taxpayer in the conduct of a business.[104]

Gain on the sale of depreciable property must be recaptured as ordinary income to the extent of depreciation deductions previously claimed,[105] and the recapture amount is computed separately for each item of property. Section 197 intangibles, because they are treated as property of a character subject to the allowance for depreciation,[106] are subject to these recapture rules.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, if multiple section 197 intangibles are sold (or otherwise disposed of) in a single transaction or series of transactions, the seller must calculate recapture as if all of the section 197 intangibles were a single asset. Thus, any gain on the sale (or other disposition) of the intangibles is recaptured as ordinary income to the extent of ordinary depreciation deductions previously claimed on any of the section 197 intangibles.

The following example illustrates present law and the Senate amendment:

Example.–In year 1, a taxpayer acquires two section 197 intangible assets for a total of $45. Asset A is assigned a cost basis of $15 and asset B is assigned a cost basis of $30. The allocation is irrelevant for amortization purposes, as the taxpayer will be entitled to a total of $3 per year ($45 divided by 15 years).

In year 6, the basis of A is $10 and the basis of B is $20. Taxpayer sells the assets for an aggregate sale price of $45, resulting in gain of $15. The character of this gain depends on the recapture amount, which depends in turn on the relative sales prices of the individual assets. Taxpayer has claimed $5 of amortization, and therefore has $5 of recapture potential, with

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[103] Sec. 197(a).

[104] Sec. 197(c).

[105] Sec. 1245.

[106] Sec. 197(f)(7).

respect to A. Taxpayer has claimed $10 of amortization, and therefore has $10 of recapture potential, with respect to B.

Under present law, if the sale proceeds are allocated $15 to A and $30 to B, the gain on assets A and B will be $5 and $10, respectively. These amounts match the recapture potential for each asset, so the full amount of the gain will be recaptured as ordinary income. However, if the sale proceeds instead are allocated $25 to A and $20 to B, the full $15 gain will be recognized with respect to A, and only $5 (full recapture potential with respect to A) will be recaptured as ordinary income. The remaining $10 of gain attributable to A will be treated as capital gain. No gain (and thus no recapture) will be recognized with respect to Asset B, and only $5 of the $15 recapture potential is recognized.

Under the Senate amendment, the taxpayer calculates recapture as if assets A and B were a single asset. For purposes of the calculation, the proceeds are $45 and the gain is $15. Because a total of $15 of amortization has been claimed with respect to assets A and B, the full $15 gain is recaptured as ordinary income.

Effective date.−The Senate amendment is effective for dispositions of property after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

L. Diesel Fuel Tax Evasion Report (sec. 5312 of the Senate amendment)

Present Law

An excise tax is imposed upon (1) the removal of any taxable fuel from a refinery or terminal, (2) the entry of any taxable fuel into the United States, or (3) the sale of any taxable fuel to any person who is not registered with the IRS to receive untaxed fuel, unless there was a prior taxable removal or entry.[107] The tax does not apply to any removal or entry of taxable fuel transferred in bulk by pipeline or vessel to a terminal or refinery if the person removing or entering the taxable fuel, the operator of such pipeline or vessel, and the operator of such terminal or refinery are registered with the Secretary.[108]

Diesel fuel and kerosene that is to be used for a nontaxable purpose will not be taxed upon removal from the terminal if it is dyed to indicate its nontaxable purpose.[109] In addition to requirement that fuel be dyed, the Secretary has the authority to prescribe marking requirements for diesel fuel and kerosene destined for a nontaxable use.[110] The Secretary has not prescribed any marking requirements.

House Bill

No provision.

Senate Amendment

The Senate amendment requires the Commissioner of the IRS to report on the availability of new technologies that can be employed to enhance the collections of the excise tax on diesel fuel and the plans of the IRS to employ such technologies. The report is to be submitted within 360 days from the date of enactment to the Senate Committees on Finance and Environment and Public Works, and the House Committees on Ways and Means and Transportation and Infrastructure.

Effective date.−The Senate amendment is effective on the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment except the conference agreement requires the report to contain certain additional information regarding the use of forensic or chemical molecular markers. Specifically, the conference agreement requires the

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[107] Sec. 4081(a)(1).

[108] Sec. 4081(a)(1)(B).

[109] Sec. 4082(a)(1) and (2).

[110] Sec. 4082(a)(3).

report to cover the availability of forensic or chemical molecular markers, in addition to other technologies, to enhance collections of the excise tax on diesel fuel and the plans of the Internal Revenue Service to employ such technologies. The report must also cover the design of three tests: (1) the design of a test to place forensic or chemical molecular markers in any excluded liquid as that term is defined in Treasury regulations; (2) the design of a test, in consultation with the Department of Defense, to place forensic or chemical molecular markers in all nonstrategic bulk fuel deliveries of diesel fuel to the military, and (3) the design of a test to place forensic or chemical molecular markers in all diesel fuel bound for export utilizing the Gulf of Mexico.

Effective date.−The provision is effective on the date of enactment.

M. Leaking Underground Storage Tank Trust Fund (sec. 9508 of the Code)

Present Law

Leaking Underground Storage Tank Trust Fund

The Code imposes an excise tax, generally at a rate of 0.1 cents per gallon, on gasoline, diesel, kerosene, and special motor fuels (other than liquefied petroleum gas and liquefied natural gas).[111] The taxes are deposited in the Leaking Underground Storage Tank ("LUST") Trust Fund. The tax expires on October 1, 2005.

Amounts in the LUST Trust Fund are available, subject to appropriation, only for purposes of making expenditures to carry out section 9003(h) of the Solid Waste Disposal Act as in effect on the date of enactment of the Superfund Amendments and Reauthorization Act of 1986.

Highway Trust Fund

The Highway Trust Fund provisions of the Code contain a special enforcement provision to prevent expenditure of Highway Trust Fund monies for purposes not authorized in section 9503 or a revenue Act.[112] If such unapproved expenditures occur, no further excise tax receipts will be transferred to the Highway Trust Fund. Rather, the taxes will continue to be imposed with receipts being retained in the General Fund. This enforcement provision provides specifically that it applies not only to unauthorized expenditures under the current Code provisions, but also to expenditures pursuant to future legislation that does not amend section 9503's expenditure authorization provisions or otherwise authorize the expenditure as part of a revenue Act.

House Bill

No provision.

Senate Amendment

No provision.

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[111] For qualified methanol and ethanol fuel the rate is 0.05 cents per gallon (sec. 4041(b)(2)(A)(ii)). Qualified methanol or ethanol fuel is any liquid at least 85 percent of which consists of methanol, ethanol or other alcohol produced from coal (including peat) (sec. 4041(b)(2)(B)).

[112] Sec. 9503(b)(6).

Conference Agreement

The conference agreement adds to the Code's LUST Trust Fund provisions a special enforcement provision similar to that applicable to the Highway Trust Fund to prevent expenditure of LUST Trust Fund monies for purposes not authorized by the Code or in a revenue Act.

Effective date.−The provision is effective on the date of enactment.

N. Revenue Provisions

1. Treatment of contingent payment convertible debt instruments (sec. 5501 of the Senate amendment)

Present Law

Under present law, a taxpayer generally deducts the amount of interest paid or accrued within the taxable year on indebtedness issued by the taxpayer. In the case of original issue discount ("OID"), the issuer of a debt instrument generally accrues and deducts, as interest, the OID over the life of the obligation, even though the amount of the OID may not be paid until the maturity of the instrument.

The amount of OID with respect to a debt instrument is equal to the excess of the stated redemption price at maturity over the issue price of the debt instrument. The stated redemption price at maturity includes all amounts that are payable on the debt instrument by maturity. The amount of OID with respect to a debt instrument is allocated over the life of the instrument through a series of adjustments to the issue price for each accrual period. The adjustment to the issue price is determined by multiplying the adjusted issue price (i.e., the issue price increased or decreased by adjustments before the accrual period) by the instrument's yield to maturity, and then subtracting any payments on the debt instrument (other than non-OID stated interest) during the accrual period. Thus, in order to compute the amount of OID and the portion of OID allocable to a particular period, the stated redemption price at maturity and the time of maturity must be known. Issuers of debt instruments with OID accrue and deduct the amount of OID as interest expense in the same manner as the holders of those instruments accrue and include in gross income the amount of OID as interest income.

Treasury regulations provide special rules for determining the amount of OID allocated to a period for certain debt instruments that provide for one or more contingent payments of principal or interest.[113] The regulations provide that a debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt instrument into the stock of the issuer, into the stock or debt of a related party, or into cash or other property in an amount equal to the approximate value of that stock or debt.[114] The regulations also provide that a payment is not a contingent payment merely because of a contingency that, as of the issue date of the debt instrument, is either remote or incidental.[115]

In the case of contingent payment debt instruments that are issued for money or publicly traded property,[116] the regulations provide that interest on a debt instrument must be taken into

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[113] Treas. Reg. sec. 1.1275-4.

[114] Treas. Reg. sec. 1.1275-4(a)(4).

[115] Treas. Reg. sec. 1.1275-4(a)(5).

[116] Treas. Reg. sec. 1.1275-4(b).

account (as OID) whether or not the amount of any payment is fixed or determinable in the taxable year. The amount of OID that is taken into account for each accrual period is determined by constructing a comparable yield and a projected payment schedule for the debt instrument, and then accruing the OID on the basis of the comparable yield and projected payment schedule by applying rules similar to those for accruing OID on a noncontingent debt instrument (the "noncontingent bond method"). If the actual amount of a contingent payment is not equal to the projected amount, appropriate adjustments are made to reflect the difference. The comparable yield for a debt instrument is the yield at which the issuer would be able to issue a fixed-rate noncontingent debt instrument with terms and conditions similar to those of the contingent payment debt instrument (i.e., the comparable fixed-rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions.[117]

Certain debt instruments, often referred to as "contingent convertible" debt instruments, are convertible into the common stock of the issuer and also provide for contingent payments (other than the conversion feature). The IRS has stated that the noncontingent bond method applies in computing the accrual of OID on these contingent convertible debt instruments.[118] In applying the noncontingent bond method, the IRS has stated that the comparable yield for a contingent convertible debt instrument is determined by reference to a comparable fixed-rate nonconvertible debt instrument, and the projected payment schedule is determined by treating the issuer stock received upon a conversion of the debt instrument as a contingent payment.

House Bill

No provision.

Senate Amendment

The provision provides that, in the case of a contingent convertible debt instrument,[119] any Treasury regulations which require OID to be determined by reference to the comparable yield of a noncontingent fixed-rate debt instrument shall be applied as requiring that such comparable yield be determined by reference to a noncontingent fixed-rate debt instrument which is convertible into stock. For purposes of applying the provision, the comparable yield shall be determined without taking into account the yield resulting from the conversion of a debt instrument into stock. Thus, the noncontingent bond method in the Treasury regulations shall be applied in a manner such that the comparable yield for contingent convertible debt instruments shall be determined by reference to comparable noncontingent fixed-rate convertible (rather than nonconvertible) debt instruments.

[117] Treas. Reg. sec. 1.1275-4(b)(4)(i)(A).

[118] Rev. Rul. 2002-31, 2002-1 C.B. 1023.

[119] Under the provision, a contingent convertible debt instrument is defined as a debt instrument that: (1) is convertible into stock of the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation; and (2) provides for contingent payments.

Effective date.−The Senate amendment is effective for debt instruments issued on or after date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Frivolous tax submissions (sec. 5502 of the Senate amendment)

Present Law

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of $500 imposed by the IRS.[120] The Code also permits the Tax Court[121] to impose a penalty of up to $25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless.[122]

House Bill

No provision.

Senate Amendment

The Senate amendment modifies the IRS-imposed penalty by increasing the amount of the penalty to up to $5,000 and by applying it to all taxpayers and to all types of Federal taxes.

The Senate amendment also modifies present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions to which this provision applies are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the Senate amendment permits the IRS to dismiss such requests. Second, the Senate amendment permits the IRS to impose a penalty of up to $5,000 for such requests, unless the taxpayer withdraws the request after being given an opportunity to do so.

The Senate amendment requires the IRS to publish a list of positions, arguments, requests, and submissions determined to be frivolous for this purpose.

Effective date.−The Senate amendment is effective with respect to submissions made and issues raised after the date on which the Secretary first prescribes the required list of frivolous positions.

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[120] Sec. 6702.

[121] Because the Tax Court generally is the only pre-payment forum available to taxpayers, it hears most of the frivolous, groundless, or dilatory arguments raised in tax cases.

[122] Sec. 6673(a).

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Increase in certain criminal penalties (sec. 5503 of the Senate amendment)

Present Law

Attempt to evade or defeat tax

In general, section 7201 imposes a criminal penalty on persons who willfully attempt to evade or defeat any tax imposed by the Code. Upon conviction, the Code provides that the penalty is up to $100,000 or imprisonment of not more than five years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $500,000.

Willful failure to file return, supply information, or pay tax

In general, section 7203 imposes a criminal penalty on persons required to make estimated tax payments, pay taxes, keep records, or supply information under the Code who willfully fails to do so. Upon conviction, the Code provides that the penalty is up to $25,000 or imprisonment of not more than one year (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $100,000.

Fraud and false statements

In general, section 7206 imposes a criminal penalty on persons who make fraudulent or false statements under the Code. Upon conviction, the Code provides that the penalty is up to $100,000 or imprisonment of not more than three years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of $500,000.

Uniform sentencing guidelines

Under the uniform sentencing guidelines established by 18 U.S.C. sec. 3571, a defendant found guilty of a criminal offense is subject to a maximum fine that is the greatest of: (a) the amount specified in the underlying provision, (b) for a felony[123] $250,000 for an individual or $500,000 for an organization, or (c) twice the gross gain if a person derives pecuniary gain from the offense. This Title 18 provision applies to all criminal provisions in the United States Code, including those in the Internal Revenue Code. For example, for an individual, the maximum fine under present law upon conviction of violating section 7206 is $250,000 or, if greater, twice the amount of gross gain from the offense.

[123] Section 7206 provides that the making of fraudulent or false statements is a felony. In addition, this offense is a felony pursuant to the classification guidelines of 18 U.S.C. sec. 3559(a)(5).

House Bill

No provision.

Senate Amendment

Attempt to evade or defeat tax

The Senate amendment increases the criminal penalty under section 7201 of the Code for individuals to $500,000 and for corporations to $1,000,000. The provision increases the maximum prison sentence to ten years.

Willful failure to file return, supply information, or pay tax

The Senate amendment increases the criminal penalty under section 7203 of the Code from a misdemeanor to a felony for aggravated failures to file. Under the provision, an aggravated failure to file is any case in which the taxpayer fails to file returns for three or more consecutive years and the aggregated tax liability during such years is $100,000 or greater. The provision imposes a penalty for an aggravated failure to file up to $500,000 for individuals and up to $1,000,000 for corporations. The provision also imposes a maximum prison sentence of ten years.

In misdemeanor cases, the provision increases the criminal penalty under section 7203 of the Code for individuals to $50,000.

Fraud and false statements

The Senate amendment increases the criminal penalty under section 7206 of the Code for individuals to $500,000 and for corporations to $1,000,000. The provision increases the maximum prison sentence to five years. The provision also provides that in no event shall the amount of the monetary penalty under this provision be less than the amount of the underpayment or overpayment attributable to fraud.

Effective date.−The Senate amendment is effective for actions and failures to act occurring after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

4. Doubling of certain penalties, fines, and interest on underpayments related to certain offshore financial arrangements (sec. 5504 of the Senate amendment)

Present Law

In general

The Code contains numerous civil penalties, such as the delinquency, accuracy-related, fraud, and assessable penalties. These civil penalties are in addition to any interest that may be due as a result of an underpayment of tax. If all or any part of a tax is not paid when due, the Code imposes interest on the underpayment, which is assessed and collected in the same manner as the underlying tax and is subject to the respective statutes of limitations for assessment and collection.

Delinquency penalties

Failure to file.–Under present law, a taxpayer who fails to file a tax return on a timely basis is generally subject to a penalty equal to five percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent. An exception from the penalty applies if the failure is due to reasonable cause. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.

Failure to pay.–Taxpayers who fail to pay their taxes are subject to a penalty of 0.5 percent per month on the unpaid amount, up to a maximum of 25 percent. If a penalty for failure to file and a penalty for failure to pay tax shown on a return both apply for the same month, the amount of the penalty for failure to file for such month is reduced by the amount of the penalty for failure to pay tax shown on a return. If a return is filed more than 60 days after its due date, then the penalty for failure to pay tax shown on a return may not reduce the penalty for failure to file below the lesser of $100 or 100 percent of the amount required to be shown on the return. For any month in which an installment payment agreement with the IRS is in effect, the rate of the penalty is half the usual rate (0.25 percent instead of 0.5 percent), provided that the taxpayer filed the tax return in a timely manner (including extensions).

Failure to make timely deposits of tax.–The penalty for the failure to make timely deposits of tax consists of a four-tiered structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure. A depositor is subject to a penalty equal to two percent of the amount of the underpayment if the failure is corrected on or before the date that is five days after the prescribed due date. A depositor is subject to a penalty equal to five percent of the amount of the underpayment if the failure is corrected after the date that is five days after the prescribed due date but on or before the date that is 15 days after the prescribed due date. A depositor is subject to a penalty equal to 10 percent of the amount of the underpayment if the failure is corrected after the date that is 15 days after the due date but on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). Finally, a depositor is subject to a penalty equal to 15 percent of the amount of the underpayment if the failure is not corrected on or before the date that is 10 days after the date of the day on which notice and demand for immediate payment of tax is given in cases of jeopardy.

An exception from the penalty applies if the failure is due to reasonable cause. In addition, the Secretary may waive the penalty for an inadvertent failure to deposit any tax by specified first-time depositors.

Accuracy-related penalties

In general.−The accuracy-related penalties are imposed at a rate of 20 percent of the portion of any underpayment that is attributable, in relevant part, to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, and (4) any reportable transaction understatement. The penalty for a substantial valuation misstatement is doubled for certain gross valuation misstatements. In the case of a reportable transaction understatement for which the transaction is not disclosed, the penalty rate is 30 percent. These penalties are coordinated with the fraud penalty. This statutory structure operates to eliminate any stacking of the penalties.

No penalty is to be imposed if it is shown that there was reasonable cause for an underpayment and the taxpayer acted in good faith, and in the case of a reportable transaction understatement the relevant facts of the transaction have been disclosed, there is or was substantial authority for the taxpayer's treatment of such transaction, and the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

Negligence or disregard for the rules or regulations.–If an underpayment of tax is attributable to negligence, the negligence penalty applies only to the portion of the underpayment that is attributable to negligence. Negligence means any failure to make a reasonable attempt to comply with the provisions of the Code. Disregard includes any careless, reckless or intentional disregard of the rules or regulations.

Substantial understatement of income tax.–Generally, an understatement is substantial if the understatement exceeds the greater of (1) 10 percent of the tax required to be shown on the return for the tax year or (2) $5,000. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return.

Substantial valuation misstatement.–A penalty applies to the portion of an underpayment that is attributable to a substantial valuation misstatement. Generally, a substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the correct value or adjusted basis. The amount of the penalty for a substantial valuation misstatement is 20 percent of the amount of the underpayment if the value or adjusted basis claimed is 200 percent or more but less than 400 percent of the correct value or adjusted basis. If the value or adjusted basis claimed is 400 percent or more of the correct value or adjusted basis, then the overvaluation is a gross valuation misstatement.

Reportable transaction understatement.–A penalty applies to any item that is attributable to any listed transaction, or to any reportable transaction (other than a listed transaction) if a significant purpose of such reportable transaction is tax avoidance or evasion.[124]

Fraud penalty

The fraud penalty is imposed at a rate of 75 percent of the portion of any underpayment that is attributable to fraud. The accuracy-related penalty does not to apply to any portion of an underpayment on which the fraud penalty is imposed.

Assessable penalties

In addition to the penalties described above, the Code imposes a number of additional penalties, including, for example, penalties for failure to file (or untimely filing of) information returns with respect to foreign trusts, and penalties for failure to disclose any required information with respect to a reportable transaction.

Interest provisions

Taxpayers are required to pay interest to the IRS whenever there is an underpayment of tax. An underpayment of tax exists whenever the correct amount of tax is not paid by the last date prescribed for the payment of the tax. The last date prescribed for the payment of the income tax is the original due date of the return.

Different interest rates are provided for the payment of interest depending upon the type of taxpayer, whether the interest relates to an underpayment or overpayment, and the size of the underpayment or overpayment. Interest on underpayments is compounded daily.

Offshore Voluntary Compliance Initiative

In January 2003, Treasury announced the Offshore Voluntary Compliance Initiative ("OVCI") to encourage the voluntary disclosure of previously unreported income placed by taxpayers in offshore accounts and accessed through credit card or other financial arrangements. A taxpayer had to comply with various requirements in order to participate in the OVCI, including sending a written request to participate in the program by April 15, 2003. This request was required to include information about the taxpayer, the taxpayer's introduction to the credit card or other financial arrangements, and the names of parties that promoted the transaction. Taxpayers entering into a closing agreement under the OVCI are not liable for civil fraud, the fraudulent

[124] A reportable transaction is any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion. A listed transaction is a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011. Sec. 6707A(c).

failure to file penalty, or the civil information return penalties. The taxpayer will pay back taxes, interest, and certain accuracy-related and delinquency penalties.[125]

Voluntary disclosure policy

A taxpayer's timely, voluntary disclosure of a substantial unreported tax liability has long been an important factor in deciding whether the taxpayer's case should ultimately be referred for criminal prosecution. The voluntary disclosure must be truthful, timely, and complete. The taxpayer must show a willingness to cooperate (as well as actual cooperation) with the IRS in determining the correct tax liability. The taxpayer must make good-faith arrangements with the IRS to pay in full the tax, interest, and any penalties determined by the IRS to be applicable. A voluntary disclosure does not guarantee immunity from prosecution. It creates no substantive or procedural rights for taxpayers.[126]

House Bill

No provision.

Senate Amendment

The Senate amendment doubles the total amount of civil penalties, interest, and fines applicable to a taxpayer who underreported its Federal tax liability with respect to any item involving a transaction of a type that was, or would have been, within the scope of the OVCI, if the taxpayer did not enter into a closing agreement pursuant to the OVCI or otherwise voluntarily disclose to the IRS its participation in such a transaction. For example, current arrangements which are the same as, or substantially similar to, the employee leasing arrangements described in Notice 2003-22 would have been within the scope of the OVCI.[127]

Under the Senate amendment, the determination of whether any civil penalty is to be imposed with respect to such a transaction (or underpayment attributable to such transaction) is made without regard to whether a return has been filed, whether there was reasonable cause for such underpayment, and whether the taxpayer acted in good faith. However, the Secretary is granted the authority to waive the application of the provision if the use of such offshore payment mechanisms is incidental to the transaction and, in the case of a trade or business, such use is conducted in the ordinary course of the trade or business engaged in by the taxpayer.

The Secretary may retain an amount not to exceed 25 percent of all amounts collected under this provision, to be used for IRS enforcement and collection activities. In addition, the Secretary must annually conduct a study and report to Congress on the implementation of this provision,

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[125] Rev. Proc. 2003-11, 2003-4 C.B. 311.

[126] Internal Revenue News Release 2002-135, IR-2002-135 (December 11, 2002).

[127] 2003-18 C.B. 851. Notice 2003-22 classified such arrangements as listed transactions.

including statistics on the number of taxpayers affected and the amounts of interest and penalties asserted, waived, and assessed.

Effective date.−The Senate amendment generally is effective with respect to a taxpayer's open tax years on or after date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

5. Modification of coordination rules for controlled foreign corporation and passive foreign investment company regimes (sec. 5505 of the Senate amendment)

Present Law

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F[128] and the passive foreign investment company rules.[129] Deferral of U.S. tax is considered appropriate, on the other hand, with respect to most types of active business income earned abroad. A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as an actual dividend, or included under one of the anti-deferral regimes.[130]

Subpart F,[131] applicable to controlled foreign corporations and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A controlled foreign corporation generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only).[132] Under the subpart F rules, the United States generally taxes the U.S.

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[128] Secs. 951-964.

[129] Secs. 1291-1298.

[130] Secs. 901, 902, 960, and 1291(g).

[131] Secs. 951-964.

[132] Secs. 951(b), 957, and 958.

10-percent shareholders of a controlled foreign corporation on their pro rata shares of certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[133]

Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[134] insurance income,[135] and certain income relating to international boycotts and other violations of public policy.[136] Foreign base company income consists of foreign personal holding company income, which includes passive income (e.g., dividends, interest, rents, and royalties), as well as a number of categories of non-passive income, including foreign base company sales income and foreign base company services income.[137]

In effect, the United States treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution out of the corporation's subpart F income. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's earnings invested in U.S. property.[138]

The Tax Reform Act of 1986 established an additional anti-deferral regime, for passive foreign investment companies. A passive foreign investment company generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[139] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a passive foreign investment company, regardless of their percentage ownership in the company. One set of rules applies to passive foreign investment companies that are "qualified electing funds," under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[140] A second set of rules applies to passive foreign investment companies that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest

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[133] Sec. 951(a).

[134] Sec. 954.

[135] Sec. 953.

[136] Sec. 952(a)(3) through (5).

[137] Sec. 954.

[138] Secs. 951(a)(1)(B) and 956.

[139] Sec. 1297.

[140] Secs. 1293 through 1295.

charge that is attributable to the value of deferral.[141] A third set of rules applies to passive foreign investment company stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "mark to market."[142]

Under section 1297(e), which was enacted in 1997 to address the overlap of the passive foreign investment company rules and subpart F, a controlled foreign corporation generally is not also treated as a passive foreign investment company with respect to a U.S. shareholder of the corporation. This exception applies regardless of the likelihood that the U.S. shareholder would actually be taxed under subpart F in the event that the controlled foreign corporation earns subpart F income. Thus, even in a case in which a controlled foreign corporation's subpart F income would be allocated to a different shareholder under the subpart F allocation rules, a U.S. shareholder would still qualify for the exception from the passive foreign investment company rules under section 1297(e).

House Bill

No provision.

Senate Amendment

The Senate amendment adds an exception to section 1297(e) for U.S. shareholders that face only a remote likelihood of incurring a subpart F inclusion in the event that a controlled foreign corporation earns subpart F income, thus preserving the potential application of the passive foreign investment company rules in such cases.

Effective date.−The Senate amendment is effective for taxable years of controlled foreign corporations beginning after March 2, 2005, and for taxable years of U.S. shareholders in which or with which such taxable years of controlled foreign corporations end.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

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[141] Sec. 1291.

[142] Sec. 1296.

6. Declaration by chief executive officer relating to Federal annual corporate income tax return (sec. 5506 of the Senate amendment)

Present Law

The Code requires that the income tax return of a corporation must be signed by either the president, the vice-president, the treasurer, the assistant treasurer, the chief accounting officer, or any other officer of the corporation authorized by the corporation to sign the return.

The Code also imposes a criminal penalty on any person who willfully signs any tax return under penalties of perjury that that person does not believe to be true and correct with respect to every material matter at the time of filing. If convicted, the person is guilty of a felony; the Code imposes a fine of not more than $100,000 ($500,000 in the case of a corporation) or imprisonment of not more than three years, or both, together with the costs of prosecution.

House Bill

No provision.

Senate Amendment

The Senate amendment requires that a corporation's Federal annual income tax return include a declaration signed under penalties of perjury by the chief executive officer of the corporation that the corporation has in place processes and procedures to ensure that the return complies with the Internal Revenue Code and that the CEO was provided reasonable assurance of the accuracy of all material aspects of the return. This declaration is part of the income tax return. The provision is in addition to the requirement of present law as to the signing of the income tax return itself. Because a CEO's duties generally do not require a detailed or technical understanding of the corporation's tax return, it is anticipated that this declaration of the CEO will be more limited in scope than the declaration of the officer required to sign the return itself.

The provision provides that the Secretary of the Treasury shall prescribe the matters to which the declaration of the CEO applies. It is intended that the declaration help insure that the preparation and completion of the corporation's tax return be given an appropriate level of care. For example, it is anticipated that the CEO would declare that processes and procedures have been implemented to ensure that the return complies with the Code and all regulations and rules promulgated thereunder. Although appropriate processes and procedures can vary for each taxpayer depending on the size and nature of the taxpayer's business, in every case the CEO should be briefed on all material aspects of the corporation's tax return by the corporation's chief financial officer (or another person authorized to sign the return under present law).

Under the Senate amendment, if the corporation does not have a chief executive officer, the IRS may designate another officer of the corporation; otherwise, no other person is permitted to sign the declaration. It is intended that the IRS issue general guidance, such as a revenue procedure, to: (1) address situations when a corporation does not have a chief executive officer; and (2) define who the chief executive officer is, in situations (for example) when the primary official bears a different title, when a corporation has multiple chief executive officers, or when

the corporation is a foreign corporation and the CEO is not a U.S. resident.[143] It is intended that, in every instance, the highest ranking corporate officer (regardless of title) sign this declaration.

The provision does not apply to the income tax returns of mutual funds;[144] they are required to be signed as under present law.

Effective date.−The Senate amendment applies to Federal annual tax returns for taxable years ending after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

7. Grant Treasury regulatory authority to address foreign tax credit transactions involving inappropriate separation of foreign taxes from related foreign income (sec. 5507 of the Senate amendment)

Present Law

The United States employs a "worldwide" tax system, under which residents generally are taxed on all income, whether derived in the United States or abroad. In order to mitigate the possibility of double taxation arising from overlapping claims of the United States and a source country to tax the same item of income, the United States provides a credit for foreign income taxes paid or accrued, subject to several conditions and limitations.

For purposes of the foreign tax credit, regulations provide that a foreign tax is treated as being paid by "the person on whom foreign law imposes legal liability for such tax."[145] Thus, for example, if a U.S. corporation owns an interest in a foreign partnership, the U.S. corporation can claim foreign tax credits for the tax that is imposed on it as a partner in the foreign entity. This would be true under the regulations even if the U.S. corporation elected to treat the foreign entity as a corporation for U.S. tax purposes. In such a case, if the foreign entity does not meet the definition of a controlled foreign corporation or does not generate income that is subject to current inclusion under the rules of subpart F, the income generated by the foreign entity might never be reported on a U.S. return, and yet the U.S. corporation might take the position that it can claim credits for taxes imposed on that income. This is one example of how a taxpayer might attempt to separate foreign taxes from the related foreign income, and thereby attempt to claim a foreign tax credit under circumstances in which there is no threat of double taxation.

[143] With respect to foreign corporations, it is intended that the rules for signing this declaration generally parallel the present-law rules for signing the return. See Treas. Reg. sec. 1.6062-1(a)(3).

[144] The provision does, however, apply to the income tax returns of mutual fund management companies and advisors.

[145] Treas. Reg. sec. 1.901-2(f)(1).

House Bill

No provision.

Senate Amendment

The Senate amendment provides regulatory authority for the Treasury Department to address transactions that involve the inappropriate separation of foreign taxes from the related foreign income in cases in which taxes are imposed on any person in respect of income of an entity. Regulations issued pursuant to this authority could provide for the disallowance of a credit for all or a portion of the foreign taxes, or for the allocation of the foreign taxes among the participants in the transaction in a manner more consistent with the economics of the transaction.

Effective date.−The Senate amendment generally is effective for transactions entered into after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

8. Whistleblower reforms (sec. 5508 of the Senate amendment)

Present Law

The Code authorizes the IRS to pay such sums as deemed necessary for: "(1) detecting underpayments of tax; and (2) detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving at the same."[146] Amounts are paid based on a percentage of tax, fines, and penalties (but not interest) actually collected based on the information provided. For specific information that caused the investigation and resulted in recovery, the IRS administratively has set the reward in an amount not to exceed 15 percent of the amounts recovered. For information, although not specific, that nonetheless caused the investigation and was of value in the determination of tax liabilities, the reward is not to exceed 10 percent of the amount recovered. For information that caused the investigation, but had no direct relationship to the determination of tax liabilities, the reward is not to exceed one percent of the amount recovered. The reward ceiling is $10 million (for payments made after November 7, 2002), and the reward floor is $100. No reward will be paid if the recovery was so small as to call for payment of less than $100 under the above formulas. Both the ceiling and percentages can be increased with a special agreement. The Code permits the IRS to disclose return information pursuant to a contract for tax administration services.[147]

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[146] Sec. 7623.

[147] Sec. 6103(n).

House Bill

No provision.

Senate Amendment

The Senate amendment reforms the reward program for individuals who provide information regarding violations of the tax laws to the Secretary. Generally, the provision establishes a reward floor of 15 percent of the collected proceeds (including penalties, interest, additions to tax and additional amounts) if the IRS moves forward with an administrative or judicial action based on information brought to the IRS's attention by an individual. The provision caps the available reward at 30 percent of the collected proceeds. The provision permits awards of lesser amounts (but no less than 10 percent) if the action was based principally on allegations (other than information provided by the individual) resulting from a judicial or administrative hearing, government report, hearing, audit, investigation, or from the news media.

The Senate amendment creates a Whistleblower Office within the IRS to administer the reward program. The Whistleblower Office may seek assistance from the individual providing information or from his or her legal representative, and may reimburse the costs incurred by any legal representative out of the amount of the reward. To the extent the disclosure of returns or return information is required to render such assistance, the disclosure must be pursuant to an IRS tax administration contract.

Effective date.−The Senate amendment is effective for information provided on or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

9. Denial of deduction for certain fines, penalties, and other amounts (sec. 5509 of the Senate amendment)

Present Law

Under present law, no deduction is allowed as a trade or business expense under section 162(a) for the payment of a fine or similar penalty to a government for the violation of any law (sec. 162(f)). The enactment of section 162(f) in 1969 codified existing case law that denied the deductibility of fines as ordinary and necessary business expenses on the grounds that "allowance of the deduction would frustrate sharply defined national or State policies proscribing the particular types of conduct evidenced by some governmental declaration thereof."[148]

[148] S. Rep. 91-552, 91st Cong, 1st Sess., 273-74 (1969), referring to *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

Treasury regulation section 1.162-21(b)(1) provides that a fine or similar penalty includes an amount: (1) paid pursuant to conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding; (2) paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Code; (3) paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or (4) forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty. Treasury regulation section 1.162-21(b)(2) provides, among other things, that compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.

House Bill

No provision.

Senate Amendment

The Senate amendment modifies the rules regarding the determination whether payments are nondeductible payments of fines or penalties under section 162(f). In particular, the Senate amendment generally provides that amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government in relation to the violation of any law or the investigation or inquiry into the potential violation of any law [149] are nondeductible under any provision of the income tax provisions.[150] The Senate amendment applies to deny a deduction for any such payments, including those where there is no admission of guilt or liability and those made for the purpose of avoiding further investigation or litigation. An exception applies to payments that the taxpayer establishes are restitution (including remediation of property) and that are identified as restitution in the court order or settlement.[151]

An exception also applies to any amount paid or incurred as taxes due.

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[149] The Senate amendment does not affect amounts paid or incurred in performing routine audits or reviews such as annual audits that are required of all organizations or individuals in a similar business sector, or profession, as a requirement for being allowed to conduct business. However, if the government or regulator raised an issue of compliance and a payment is required in settlement of such issue, the Senate amendment would affect that payment.

[150] The Senate amendment provides that such amounts are nondeductible under chapter 1 of the Internal Revenue Code.

[151] The Senate amendment does not affect the treatment of antitrust payments made under section 4 of the Clayton Act, which will continue to be governed by the provisions of section 162(g).

The Senate amendment is intended to apply only where a government (or other entity treated in a manner similar to a government under the amendment) is a complainant or investigator with respect to the violation or potential violation of any law.[152]

It is intended that a payment will be treated as restitution only if substantially all of the payment is required to be paid to the specific persons, or in relation to the specific property, actually harmed by the conduct of the taxpayer that resulted in the payment. Thus, a payment to or with respect to a class substantially broader than the specific persons or property that were actually harmed (e.g., to a class including similarly situated persons or property) does not qualify as restitution.[153] Restitution is limited to the amount that bears a substantial quantitative relationship to the harm caused by the past conduct or actions of the taxpayer that resulted in the payment in question. If the party harmed is a government or other entity, then restitution includes payment to such harmed government or entity, provided the payment bears a substantial quantitative relationship to the harm. However, restitution does not include reimbursement of government investigative or litigation costs, or payments to whistleblowers.

Amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, any self-regulatory entity that regulates a financial market or other market that is a qualified board or exchange under section 1256(g)(7), and that is authorized to impose sanctions (e.g., the National Association of Securities Dealers) are likewise subject to the provision if paid in relation to a violation, or investigation or inquiry into a potential violation, of any law (or any rule or other requirement of such entity). To the extent provided in regulations, amounts paid or incurred to, or at the direction of, any other nongovernmental entity that exercises self-regulatory powers as part of performing an essential governmental function are similarly subject to the provision. The exception for payments that the taxpayer establishes are restitution likewise applies in these cases.

No inference is intended as to the treatment of payments as nondeductible fines or penalties under present law. In particular, the Senate amendment is not intended to limit the scope of present-law section 162(f) or the regulations thereunder.

Effective date.−The Senate amendment is effective for amounts paid or incurred on or after the date of enactment; however the Senate amendment does not apply to amounts paid or incurred under any binding order or agreement entered into before such date. Any order or

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[152] Thus, for example, the Senate amendment would not apply to payments made by one private party to another in a lawsuit between private parties, merely because a judge or jury acting in the capacity as a court directs the payment to be made. The mere fact that a court enters a judgment or directs a result in a private dispute does not cause a payment to be made "at the direction of a government" for purposes of the provision.

[153] Similarly, a payment to a charitable organization benefiting a broader class than the persons or property actually harmed, or to be paid out without a substantial quantitative relationship to the harm caused, would not qualify as restitution. Under the Senate amendment, such a payment not deductible under section 162 would also not be deductible under section 170.

agreement requiring court approval is not a binding order or agreement for this purpose unless such approval was obtained before the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

10. Freeze of interest suspension rules with respect to listed transactions (sec. 5510 of the Senate amendment)

Present Law

In general, interest and penalties accrue during periods for which taxes were unpaid without regard to whether the taxpayer was aware that there was tax due. The Code suspends the accrual of certain penalties and interest starting 18 months after the filing of the tax return[154] if the IRS has not sent the taxpayer a notice specifically stating the taxpayer's liability and the basis for the liability within the specified period. Interest and penalties resume 21 days after the IRS sends the required notice to the taxpayer. The provision is applied separately with respect to each item or adjustment. The provision does not apply where a taxpayer has self-assessed the tax. The suspension only applies to taxpayers who file a timely tax return. The provision applies only to individuals and does not apply to the failure to pay penalty, in the case of fraud, or with respect to criminal penalties.

The suspension of interest does not apply to interest accruing after October 3, 2004 with respect to underpayments resulting from listed transactions or undisclosed reportable transactions.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, the exception for listed transactions (but not the exception for undisclosed reportable transactions) also applies to interest accruing on or before October 3, 2004. However, taxpayers remain eligible for the present-law suspension of interest if, as of May 9, 2005, (1) the taxpayer is participating in (and eventually reaches resolution via) a published IRS settlement initiative with respect to the listed transaction, or (2) the year in which the underpayment occurred is barred by the statute of limitations as of May 9, 2005.

Effective date.−The Senate amendment is effective as if included in the provisions of the American Jobs Creation Act of 2004 to which it relates.

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[154] If the return is filed before the due date, for this purpose it is considered to have been filed on the due date.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

11. Repeal loss deferral exception for qualified transportation property (sec. 5511 of the Senate amendment)

Present Law

Present law provides for the deferral of losses attributable to certain tax exempt use property, generally effective for leases entered into after March 12, 2004. However, the deferral provision does not apply to property located in the United States that is subject to a lease with respect to which a formal application: (1) was submitted for approval to the Federal Transit Administration (an agency of the Department of Transportation) after June 30, 2003, and before March 13, 2004; (2) is approved by the Federal Transit Administration before January 1, 2006; and (3) includes a description and the fair market value of such property.

House Bill

No provision.

Senate Amendment

The Senate amendment repeals the exception for Federal Transit Administration approved leases so that the general effective date of the present law loss deferral provisions applies to such leases.

Effective date.−The Senate amendment is effective as if included in the enactment of the American Jobs Creation Act of 2004.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

12. Impose mark to market tax on individuals who expatriate (sec. 5512 of Senate amendment)

Present Law

In general

U.S. citizens and residents generally are subject to U.S income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. trade or business. The estates of nonresident aliens generally are subject to estate tax on U.S.-situated property (e.g., real estate and tangible property located within the United States and stock in a U.S.

corporation). Nonresident aliens generally are subject to gift tax on transfers by gift of U.S.-situated property (e.g., real estate and tangible property located within the United States, but excluding intangibles, such as stock, regardless of where they are located).

Income tax rules with respect to expatriates

For the 10 taxable years after an individual relinquishes his or her U.S. citizenship or terminates his or her U.S. residency[155] with a principal purpose of avoiding U.S. taxes, the individual is subject to an alternative method of income taxation that is generally applicable to nonresident aliens (the "alternative tax regime"). Generally, the individual is subject to income tax only on U.S.-source income[156] at the rates applicable to U.S. citizens for the 10-year period.

A former citizen or former long-term resident is subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $127,000 for 2005 (adjusted annually for inflation)[157] and his or her net worth does not exceed $2 million, or alternatively satisfies limited, objective exceptions for dual citizens and minors who have had no substantial contact with the United States; and (2) certifies under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years and provides such evidence of compliance as the Secretary of the Treasury may require.

The alternative tax regime does not apply to any individual for any taxable year during the 10-year period following citizenship relinquishment or residency termination if such individual is present in the United States for more than 30 days in the calendar year ending in such taxable year. Instead, such individual is treated as a U.S. citizen or resident for such taxable year and therefore is taxed on his or her worldwide income.

Gifts of stock of certain closely-held foreign corporations by a former citizen or former long-term resident who is subject to the alternative tax regime are subject to gift tax if the gift is made within the 10-year period after citizenship relinquishment or residency termination. The gift tax rule applies if: (1) the former citizen or former long-term resident, before making the gift, directly or indirectly owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation; and (2) directly or indirectly, is considered to own more than 50 percent of (a) the total combined voting power of all classes of

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[155] An individual continues to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes, including for purposes of section 7701(b)(10), until the individual: (1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, respectively; and (2) provides a statement in accordance with section 6039G.

[156] For this purpose, however, U.S.-source income has a broader scope than it does typically in the Code.

[157] Rev. Proc. 2004-71, 2004-50 I.R.B. 970.

stock entitled to vote in the foreign corporation, or (b) the total value of the stock of such corporation. If this stock ownership test is met, then taxable gifts of the former citizen or former long-term resident include that proportion of the fair market value of the foreign stock transferred by the individual, at the time of the gift, which the fair market value of any assets owned by such foreign corporation and situated in the United States (at the time of the gift) bears to the total fair market value of all assets owned by such foreign corporation (at the time of the gift).

This gift tax rule applies to a former citizen or former long-term resident who is subject to the alternative tax regime and who owns stock in a foreign corporation at the time of the gift, regardless of how such stock was acquired (e.g., whether issued originally to the donor, purchased, or received as a gift or bequest).

Former citizens and former long-term residents are required to file an annual return for each year following citizenship relinquishment or residency termination in which they are subject to the alternative tax regime. The annual return is required even if no U.S. Federal income tax is due. The annual return requires certain information, including information on the permanent home of the individual, the individual's country of residence, the number of days the individual was present in the United States for the year, and detailed information about the individual's income and assets that are subject to the alternative tax regime. This requirement includes information relating to foreign stock potentially subject to the special estate tax rule of section 2107(b) and the gift tax rules.

If the individual fails to file the statement in a timely manner or fails correctly to include all the required information, the individual is required to pay a penalty of $5,000. The $5,000 penalty does not apply if it is shown that the failure is due to reasonable cause and not to willful neglect.

House Bill

No provision.

Senate Amendment

In general

The Senate amendment generally subjects certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who terminate their U.S. residence to tax on the net unrealized gain in their property as if such property were sold for fair market value on the day before the expatriation or residency termination. Gain from the deemed sale is taken into account at that time without regard to other Code provisions; any loss from the deemed sale generally would be taken into account to the extent otherwise provided in the Code. Any net gain on the deemed sale is recognized to the extent it exceeds $600,000 ($1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency). The $600,000 amount would be increased by a cost of living adjustment factor for calendar years after 2005.

Individuals covered

Under the provision, the mark-to-market tax applies to U.S. citizens who relinquish citizenship and long-term residents who terminate U.S. residency. An individual is a long-term resident if he or she was a lawful permanent resident for at least eight out of the 15 taxable years ending with the year in which the termination of residency occurs. An individual is considered to terminate long-term residency when either the individual ceases to be a lawful permanent resident (i.e., loses his or her green card status), or the individual is treated as a resident of another country under a tax treaty and the individual does not waive the benefits of the treaty.

Exceptions from the mark-to-market tax are provided in two situations. The first exception applies to an individual who was born with citizenship both in the United States and in another country; provided that (1) as of the expatriation date the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual was not a resident of the United States for the five taxable years ending with the year of expatriation. The second exception applies to a U.S. citizen who relinquishes U.S. citizenship before reaching age 18 and a half, provided that the individual was a resident of the United States for no more than five taxable years before such relinquishment.

Election to be treated as a U.S. citizen

Under the provision, an individual is permitted to make an irrevocable election to continue to be taxed as a U.S. citizen with respect to all property that otherwise is covered by the expatriation tax. This election is an "all or nothing" election; an individual is not permitted to elect this treatment for some property but not for other property. The election, if made, would apply to all property that would be subject to the expatriation tax and to any property the basis of which is determined by reference to such property. Under this election, the individual would continue to pay U.S. income taxes at the rates applicable to U.S. citizens following expatriation on any income generated by the property and on any gain realized on the disposition of the property. In addition, the property would continue to be subject to U.S. gift, estate, and generation-skipping transfer taxes. In order to make this election, the taxpayer would be required to waive any treaty rights that would preclude the collection of the tax.

The individual also would be required to provide security to ensure payment of the tax under this election in such form, manner, and amount as the Secretary of the Treasury requires. The amount of mark-to-market tax that would have been owed but for this election (including any interest, penalties, and certain other items) shall be a lien in favor of the United States on all U.S.-situs property owned by the individual. This lien shall arise on the expatriation date and shall continue until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this provision. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this provision.

Date of relinquishment of citizenship

Under the provision, an individual is treated as having relinquished U.S. citizenship on the earliest of four possible dates: (1) the date that the individual renounces U.S. nationality before a diplomatic or consular officer of the United States (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (2) the date that the individual furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act (again, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (3) the date that the State Department issues a certificate of loss of nationality; or (4) the date that a U.S. court cancels a naturalized citizen's certificate of naturalization.

Deemed sale of property upon expatriation or residency termination

The deemed sale rule of the provision generally applies to all property interests held by the individual on the date of relinquishment of citizenship or termination of residency. Special rules apply in the case of trust interests, as described below. U.S. real property interests, which remain subject to U.S. tax in the hands of nonresident noncitizens, generally are excepted from the provision. Regulatory authority is granted to the Treasury to except other types of property from the provision.

Under the provision, an individual who is subject to the mark-to-market tax is required to pay a tentative tax equal to the amount of tax that would be due for a hypothetical short tax year ending on the date the individual relinquished citizenship or terminated residency. Thus, the tentative tax is based on all income, gain, deductions, loss, and credits of the individual for the year through such date, including amounts realized from the deemed sale of property. The tentative tax is due on the 90th day after the date of relinquishment of citizenship or termination of residency.

Retirement plans and similar arrangements

Subject to certain exceptions, the provision applies to all property interests held by the individual at the time of relinquishment of citizenship or termination of residency. Accordingly, such property includes an interest in an employer-sponsored retirement plan or deferred compensation arrangement as well as an interest in an individual retirement account or annuity (i.e., an IRA).[158] However, the provision contains a special rule for an interest in a "qualified retirement plan." For purposes of the provision, a "qualified retirement plan" includes an employer-sponsored qualified plan (sec. 401(a)), a qualified annuity (sec. 403(a)), a tax-sheltered annuity (sec. 403(b)), an eligible deferred compensation plan of a governmental employer (sec. 457(b)), or an IRA (sec. 408). The special retirement plan rule applies also, to the extent provided in regulations, to any foreign plan or similar retirement arrangement or program. An

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[158] Application of the provision is not limited to an interest that meets the definition of property under section 83 (relating to property transferred in connection with the performance of services).

interest in a trust that is part of a qualified retirement plan or other arrangement that is subject to the special retirement plan rule is not subject to the rules for interests in trusts (discussed below).

Under the special rule, an amount equal to the present value of the individual's vested, accrued benefit under a qualified retirement plan is treated as having been received by the individual as a distribution under the plan on the day before the individual's relinquishment of citizenship or termination of residency. It is not intended that the plan would be deemed to have made a distribution for purposes of the tax-favored status of the plan, such as whether a plan may permit distributions before a participant has severed employment. In the case of any later distribution to the individual from the plan, the amount otherwise includible in the individual's income as a result of the distribution is reduced to reflect the amount previously included in income under the special retirement plan rule. The amount of the reduction applied to a distribution is the excess of: (1) the amount included in income under the special retirement plan rule over (2) the total reductions applied to any prior distributions. However, under the provision, the retirement plan, and any person acting on the plan's behalf, will treat any later distribution in the same manner as the distribution would be treated without regard to the special retirement plan rule.

It is expected that the Treasury Department will provide guidance for determining the present value of an individual's vested, accrued benefit under a qualified retirement plan, such as the individual's account balance in the case of a defined contribution plan or an IRA, or present value determined under the qualified joint and survivor annuity rules applicable to a defined benefit plan (sec. 417(e)).

<u>Deferral of payment of tax</u>

Under the provision, an individual is permitted to elect to defer payment of the mark-to-market tax imposed on the deemed sale of the property. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. Under this election, the mark-to-market tax attributable to a particular property is due when the property is disposed of (or, if the property is disposed of in whole or in part in a nonrecognition transaction, at such other time as the Secretary may prescribe). The mark-to-market tax attributable to a particular property is an amount that bears the same ratio to the total mark-to-market tax for the year as the gain taken into account with respect to such property bears to the total gain taken into account under these rules for the year. The deferral of the mark-to-market tax may not be extended beyond the individual's death.

In order to elect deferral of the mark-to-market tax, the individual is required to provide adequate security to the Treasury to ensure that the deferred tax and interest will be paid. Other security mechanisms are permitted provided that the individual establishes to the satisfaction of the Secretary that the security is adequate. In the event that the security provided with respect to a particular property subsequently becomes inadequate and the individual fails to correct the situation, the deferred tax and the interest with respect to such property will become due. As a further condition to making the election, the individual is required to consent to the waiver of any treaty rights that would preclude the collection of the tax.

The deferred amount (including any interest, penalties, and certain other items) shall be a lien in favor of the United States on all U.S.-situs property owned by the individual. This lien shall arise on the expatriation date and shall continue until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this provision. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this provision.

Interests in trusts

Under the provision, detailed rules apply to trust interests held by an individual at the time of relinquishment of citizenship or termination of residency. The treatment of trust interests depends on whether the trust is a qualified trust. A trust is a qualified trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust.

Constructive ownership rules apply to a trust beneficiary that is a corporation, partnership, trust, or estate. In such cases, the shareholders, partners, or beneficiaries of the entity are deemed to be the direct beneficiaries of the trust for purposes of applying these provision. In addition, an individual who holds (or who is treated as holding) a trust instrument at the time of relinquishment of citizenship or termination of residency is required to disclose on his or her tax return the methodology used to determine his or her interest in the trust, and whether such individual knows (or has reason to know) that any other beneficiary of the trust uses a different method.

Nonqualified trusts.–If an individual holds an interest in a trust that is not a qualified trust, a special rule applies for purposes of determining the amount of the mark-to-market tax due with respect to such trust interest. The individual's interest in the trust is treated as a separate trust consisting of the trust assets allocable to such interest. Such separate trust is treated as having sold its net assets as of the date of relinquishment of citizenship or termination of residency and having distributed the assets to the individual, who then is treated as having recontributed the assets to the trust. The individual is subject to the mark-to-market tax with respect to any net income or gain arising from the deemed distribution from the trust.

The election to defer payment is available for the mark-to-market tax attributable to a nonqualified trust interest. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. A beneficiary's interest in a nonqualified trust is determined under all the facts and circumstances, including the trust instrument, letters of wishes, and historical patterns of trust distributions.

Qualified trusts.–If an individual has an interest in a qualified trust, the amount of unrealized gain allocable to the individual's trust interest is calculated at the time of expatriation or residency termination. In determining this amount, all contingencies and discretionary interests are assumed to be resolved in the individual's favor (i.e., the individual is allocated the maximum amount that he or she could receive). The mark-to-market tax imposed on such gains is collected when the individual receives distributions from the trust, or if earlier, upon the

individual's death. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments.

If an individual has an interest in a qualified trust, the individual is subject to the mark-to-market tax upon the receipt of distributions from the trust. These distributions also may be subject to other U.S. income taxes. If a distribution from a qualified trust is made after the individual relinquishes citizenship or terminates residency, the mark-to-market tax is imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates, but in no event will the tax imposed exceed the deferred tax amount with respect to the trust interest. For this purpose, the deferred tax amount is equal to: (1) the tax calculated with respect to the unrealized gain allocable to the trust interest at the time of expatriation or residency termination; (2) increased by interest thereon; and (3) reduced by any mark-to-market tax imposed on prior trust distributions to the individual.

If any individual's interest in a trust is vested as of the expatriation date (e.g., if the individual's interest in the trust is non-contingent and non-discretionary), the gain allocable to the individual's trust interest is determined based on the trust assets allocable to his or her trust interest. If the individual's interest in the trust is not vested as of the expatriation date (e.g., if the individual's trust interest is a contingent or discretionary interest), the gain allocable to his or her trust interest is determined based on all of the trust assets that could be allocable to his or her trust interest, determined by resolving all contingencies and discretionary powers in the individual's favor. In the case where more than one trust beneficiary is subject to the expatriation tax with respect to trust interests that are not vested, the rules are intended to apply so that the same unrealized gain with respect to assets in the trust is not taxed to both individuals.

Mark-to-market taxes become due if the trust ceases to be a qualified trust, the individual disposes of his or her qualified trust interest, or the individual dies. In such cases, the amount of mark-to-market tax equals the lesser of (1) the tax calculated under the rules for nonqualified trust interests as of the date of the triggering event, or (2) the deferred tax amount with respect to the trust interest as of that date.

The tax that is imposed on distributions from a qualified trust generally is deducted and withheld by the trustees. If the individual does not agree to waive treaty rights that would preclude collection of the tax, the tax with respect to such distributions is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against such individual with respect to the tax. Similar rules apply when the qualified trust interest is disposed of, the trust ceases to be a qualified trust, or the individual dies.

Coordination with present-law alternative tax regime

The provision provides a coordination rule with the present-law alternative tax regime. Under the provision, the expatriation income tax rules under section 877, and the expatriation estate and gift tax rules under sections 2107 and 2501(a)(3) (described above), do not apply to a former citizen or former long-term resident whose expatriation or residency termination occurs on or after date of enactment. In addition, section 7701(n) does not apply with respect to any individual that expatriated on or after date of enactment.

Treatment of gifts and inheritances from a former citizen or former long-term resident

Under the provision, the exclusion from income provided in section 102 (relating to exclusions from income for the value of property acquired by gift or inheritance) does not apply to the value of any property received by gift or inheritance from a former citizen or former long-term resident (i.e., an individual who relinquished U.S. citizenship or terminated U.S. residency), subject to the exceptions described above relating to certain dual citizens and minors. Accordingly, a U.S. taxpayer who receives a gift or inheritance from such an individual is required to include the value of such gift or inheritance in gross income and is subject to U.S. tax on such amount. Having included the value of the property in income, the recipient would then take a basis in the property equal to that value. The tax does not apply to property that is shown on a timely filed gift tax return and that is a taxable gift by the former citizen or former long-term resident, or property that is shown on a timely filed estate tax return and included in the gross U.S. estate of the former citizen or former long-term resident (regardless of whether the tax liability shown on such a return is reduced by credits, deductions, or exclusions available under the estate and gift tax rules). In addition, the tax does not apply to property in cases in which no estate or gift tax return is required to be filed, where no such return would have been required to be filed if the former citizen or former long-term resident had not relinquished citizenship or terminated residency, as the case may be. Applicable gifts or bequests that are made in trust are treated as made to the beneficiaries of the trust in proportion to their respective interests in the trust.

Immigration rules

The provision amends the immigration rules that deny tax-motivated expatriates reentry into the United States by removing the requirement that the expatriation be tax-motivated, and instead denies former citizens reentry into the United States if the individual is determined not to be in compliance with his or her tax obligations under the provision's expatriation tax provisions (regardless of the subjective motive for expatriating). For this purpose, the provision permits the IRS to disclose certain items of return information of an individual, upon written request of the Attorney General or his delegate, as is necessary for making a determination under section 212(a)(10)(E) of the Immigration and Nationality Act. Specifically, the provision would permit the IRS to disclose to the agency administering section 212(a)(10)(E) whether such taxpayer is in compliance with section 877A and identify the items of noncompliance. Recordkeeping requirements, safeguards, and civil and criminal penalties for unauthorized disclosure or inspection would apply to return information disclosed under this provision.

Effective date.−The Senate amendment generally is effective for U.S. citizens who relinquish citizenship or long-term residents who terminate their residency on or after date of enactment. The provisions relating to gifts and inheritances are effective for gifts and inheritances received from former citizens and former long-term residents on or after date of enactment, whose expatriation or residency termination occurs on or after such date. The provisions relating to former citizens under U.S. immigration laws are effective on or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

13. Disallowance of deduction for punitive damages (sec. 5513 of the Senate amendment)

Present Law

In general, a deduction is allowed for all ordinary and necessary expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business.[159] However, no deduction is allowed for any payment that is made to an official of any governmental agency if the payment constitutes an illegal bribe or kickback or if the payment is to an official or employee of a foreign government and is illegal under Federal law.[160] In addition, no deduction is allowed under present law for any fine or similar payment made to a government for violation of any law.[161] Furthermore, no deduction is permitted for two-thirds of any damage payments made by a taxpayer who is convicted of a violation of the Clayton antitrust law or any related antitrust law.[162]

In general, gross income does not include amounts received on account of personal physical injuries and physical sickness.[163] However, this exclusion does not apply to punitive damages.[164]

House Bill

No provision.

Senate Amendment

The Senate amendment denies any deduction for punitive damages that are paid or incurred by the taxpayer as a result of a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, any such punitive damages paid by the insurer are included in gross income of the insured person and the insurer is required to report such amounts to both the insured person and the IRS.

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[159] Sec. 162(a).

[160] Sec. 162(c).

[161] Sec. 162(f).

[162] Sec. 162(g).

[163] Sec. 104(a).

[164] Sec. 104(a)(2).

Effective date.–The Senate amendment is effective for punitive damages that are paid or incurred on or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

14. Application of earnings stripping rules to partners which are corporations (sec. 5514 of the Senate amendment)

Present Law

Present law provides rules to limit the ability of U.S. corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Section 163(j) specifically addresses earnings stripping involving interest payments, by limiting the deductibility of interest paid to certain related parties ("disqualified interest"),[165] if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Disallowed interest amounts can be carried forward indefinitely. In addition, excess limitation (i.e., any excess of the 50-percent limit over a company's net interest expense for a given year) can be carried forward three years.

Proposed Treasury regulations provide that a corporate partner's proportionate share of the liabilities of a partnership is treated as liabilities incurred directly by the corporate partner for purposes of applying the earnings stripping limitation to its own interest payments.[166] The proposed Treasury regulations provide that interest paid or accrued to a partnership is treated as paid or accrued to the partners of the partnership in proportion to each partner's distributive share of the partnership's interest income for the taxable year.[167] In addition, the proposed Treasury regulations provide that interest expense paid or accrued by a partnership is treated as paid or accrued by the partners of the partnership in proportion to each partner's distributive share, for purposes of the earnings stripping rules.[168]

House Bill

No provision.

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[165] This interest also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.

[166] Prop. Treas. Reg. sec. 1.163(j)-3(b)(3).

[167] Prop. Treas. Reg. sec. 1.163(j)-2(e)(4).

[168] Prop. Treas. Reg. sec. 1.163(j)-2(e)(5).

Senate Amendment

The Senate amendment codifies the approach of the proposed Treasury regulations by providing that a corporate partner's share of partnership debt is attributed to the corporate partner for purposes of applying the earnings stripping rules to the corporate partner.

Effective date.−The Senate amendment is effective for taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

15. Prohibition on deferral of certain stock option and restricted stock gains (sec. 5515 of the Senate amendment)

Present Law

Section 83 applies to transfers of property in connection with the performance of services. Under section 83, if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of such property over the amount (if any) paid for the property is includible in income at the first time that the property is transferable or not subject to substantial risk of forfeiture.

Stock granted to an employee (or other service provider) is subject to the rules that apply under section 83. When stock is vested and transferred to an employee, the excess of the fair market value of the stock over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which the transfer occurs.

The income taxation of a nonqualified stock option is determined under section 83 and depends on whether the option has a readily ascertainable fair market value. If the nonqualified option does not have a readily ascertainable fair market value at the time of grant, no amount is includible in the gross income of the recipient with respect to the option until the recipient exercises the option. The transfer of stock on exercise of the option is subject to the general rules of section 83. That is, if vested stock is received on exercise of the option, the excess of the fair market value of the stock over the option price is includible in the recipient's gross income as ordinary income in the taxable year in which the option is exercised. If the stock received on exercise of the option is not vested, the excess of the fair market value of the stock at the time of vesting over the option price is includible in the recipient's income for the year in which vesting occurs unless the recipient elects to apply section 83 at the time of exercise.

Other forms of stock-based compensation are also subject to the rules of section 83.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, gains attributable to stock options (including exercises of stock options), vesting of restricted stock, and other compensation based on employer securities (including employer securities) cannot be deferred by exchanging such amounts for a right to receive a future payment. Except as provided by the Secretary, if a taxpayer exchanges (1) an option to purchase employer securities, (2) employer securities, or (3) any other property based on employer securities for a right to receive future payments, an amount equal to the present value of such right (or such other amount as the Secretary specifies) is required to be included in gross income for the taxable year of the exchange. The provision applies even if the future right to payment is treated as an unfunded and unsecured promise to pay. The provision applies when there is in substance an exchange, even if the transaction is not formally structured as an exchange.

The provision is not intended to imply that such practices result in permissive deferral of income under present law.

Effective date.−The Senate amendment is effective for exchanges after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

16. Limitation on employer deduction for certain entertainment expenses (sec. 5516 of the Senate amendment)

Present Law

In general

Under present law, no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement or recreation, unless the taxpayer establishes that the item was directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business, or (2) a facility (e.g., an airplane) used in connection with such activity.[169] The Code includes a number of exceptions to the general rule disallowing deductions of entertainment expenses. Under one exception, the deduction disallowance rule does not apply to expenses for goods, services, and facilities to the extent that the expenses are reported by the taxpayer as compensation and wages to an employee.[170] The deduction disallowance rule also does not apply to expenses paid or incurred by the taxpayer for goods, services, and facilities to the extent that the expenses are includible in the gross income of a recipient who is not an employee (e.g., a nonemployee director) as compensation for services rendered or as a prize or

[169] Sec. 274(a).

[170] Sec. 274(e)(2). As discussed below, a special rule applies in the case of specified individuals.

award.[171] The exceptions apply only to the extent that amounts are properly reported by the company as compensation and wages or otherwise includible in income. In no event can the amount of the deduction exceed the amount of the actual cost, even if a greater amount is includible in income.

Except as otherwise provided, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. In general, an employee or other service provider must include in gross income the amount by which the fair value of a fringe benefit exceeds the amount paid by the individual. Treasury regulations provide rules regarding the valuation of fringe benefits, including flights on an employer-provided aircraft.[172] In general, the value of a non-commercial flight is determined under the base aircraft valuation formula, also known as the Standard Industry Fare Level formula or "SIFL".[173] If the SIFL valuation rules do not apply, the value of a flight on a company-provided aircraft is generally equal to the amount that an individual would have to pay in an arm's-length transaction to charter the same or a comparable aircraft for that period for the same or a comparable flight.[174]

In the context of an employer providing an aircraft to employees for nonbusiness (e.g., vacation) flights, the exception for expenses treated as compensation was interpreted in *Sutherland Lumber-Southwest, Inc. v. Commissioner* ("*Sutherland Lumber*") as not limiting the company's deduction for operation of the aircraft to the amount of compensation reportable to its employees,[175] which can result in a deduction many times larger than the amount required to be included in income. In many cases, the individual including amounts attributable to personal travel in income directly benefits from the enhanced deduction, resulting in a net deduction for the personal use of the company aircraft.

Specified individuals

In the case of specified individuals, the exceptions to the general entertainment expense disallowance rule for expenses treated as compensation or includible in income apply only to the extent of the amount of expenses treated as compensation or includible in income of the specified individual. For example, a company's deduction attributable to aircraft operating costs and other expenses for a specified individual's vacation use of a company aircraft is limited to the amount reported as compensation to the specified individual. *Sutherland Lumber* was overturned with respect to specified individuals.

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[171] Sec. 274(e)(9).

[172] Treas. Reg. sec. 1.61-21.

[173] Treas. Reg. sec. 1.61-21(g).

[174] Treas. Reg. sec. 1.61-21(b)(6).

[175] *Sutherland Lumber-Southwest, Inc. v. Comm.*, 114 T.C. 197 (2000), *aff'd*, 255 F.3d 495 (8th Cir. 2001), *acq.*, AOD 2002-02 (Feb. 11, 2002).

Specified individuals are individuals who, with respect to an employer or other service recipient, are subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934, or would be subject to such requirements if the employer or service recipient were an issuer of equity securities referred to in section 16(a). Such individuals generally include officers (as defined by section 16(a)),[176] directors, and 10-percent-or-greater owners of private and publicly-held companies.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, in the case of all individuals, the exceptions to the general entertainment expense disallowance rule for expenses treated as compensation or includible in income apply only to the extent of the amount of expenses treated as compensation or includible in income. Thus, under those exceptions, no deduction is allowed with respect to expenses for (1) a nonbusiness activity generally considered to be entertainment, amusement or recreation, or (2) a facility (e.g., an airplane) used in connection with such activity to the extent that such expenses exceed the amount treated as compensation or includible in income. The provision is intended to overturn *Sutherland Lumber* for all individuals. As under present law, the exceptions apply only if amounts are properly reported by the company as compensation and wages or otherwise includible in income.

Effective date.−The Senate amendment is effective for expenses incurred after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

17. Increase in penalty for bad checks and money orders (sec. 5517 of the Senate amendment)

Present Law

The Code imposes a penalty for bad checks and money orders on the person who tendered such check or money order.[177] The penalty is two percent of the amount of the bad

[176] An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

[177] Sec. 6657.

check or money order. The minimum penalty is $15 (or, if less, the amount of the check), applicable to checks that are less than $750.

House Bill

No provision.

Senate Amendment

The Senate amendment increases the minimum penalty for bad checks and money orders to $25 (or, if less, the amount of the check), applicable to checks that are less than $1,250.

Effective date.−The Senate amendment applies to checks or money orders received after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

18. Elimination of double deduction of mining exploration and development costs under the minimum tax (sec. 5518 of the Senate amendment)

Present Law

Under present law, mining development costs are expensed in computing taxable income, unless either the deferred expense method is elected under section under section 616(b) or 10-year amortization is elected under section 59(e). In addition, a taxpayer may elect to expense mining exploration costs under section 617 or amortize the costs over a 10-year period under section 59(e). Also, a deduction for depletion is allowed with respect to mines. One method of computing the allowance for depletion is the percentage depletion method under section 613 that is based on the income of the mining property and is not limited by the adjusted basis of the property.

In determining alternative minimum taxable income ("AMTI") mining exploration and development costs with respect to a mine are required to be capitalized and amortized over a 10-year period, unless the deferred expense method is elected under section 616(b).[178] In addition, the deduction for percentage depletion is limited to the adjusted basis of the property at the end of the taxable year (without regard to the depletion deduction for the year).[179] Treasury regulations[180] provide that the adjusted basis for this purpose is the same as the adjusted basis for purposes of determining gain or loss from the sale or other disposition of the property. Treasury

[178] Sec. 56(a)(2).

[179] Sec. 57(a)(1).

[180] Treas. Reg. sec. 1.57-1(h)(3).

regulations[181] further provide that the expenditures for development and exploration of mines treated as deferred expenses are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The adjusted basis of the property is reduced by depletion deductions and the deductions for mining and exploration expenses in the taxable year the deductions are allowable.

Under the rules, notwithstanding the adjusted basis limitation on percentage depletion, a taxpayer may deduct more than 100 percent of its exploration and development costs in computing AMTI. For example, assume a taxpayer incurs $1 million in development costs in 2005 with respect to a mine that has a zero basis and that the deferred expense method is not elected. Also, assume that the deduction for percentage depletion (without regard to the basis limitation) for 2005 is $900,000. Under present law, in computing AMTI, the taxpayer is allowed to deduct $100,000 per year in development costs for each of the 10 taxable years beginning in 2005, and, in addition, is allowed to deduct percentage depletion of $900,000 in 2005, for a total of $1.9 million in deductions.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, the deduction for depletion under the alternative minimum tax is amended by excluding from the adjusted basis of any mining property, the amount of mining exploration and development costs that may be allowed as a deduction to the taxpayer in computing AMTI in a future taxable year.

In the example described under present law, the $1 million development costs will be amortized over a 10-year period and no amount will be allowed as a deduction for depletion in computing AMTI.[182]

Effective date.−The Senate amendment applies to taxable years beginning after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

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[181] Treas. Reg. sec. 1.1016-5(f).

[182] If the taxpayer elects the deferred expense method under section 616(b) or 10-year amortization under section 59(e), the deduction for depletion will also be zero.

19. Clarification of the economic substance doctrine (sec. 5521 of the Senate amendment)

Present Law

In general

The Code provides specific rules regarding the computation of taxable income, including the amount, timing, source, and character of items of income, gain, loss and deduction. These rules are designed to provide for the computation of taxable income in a manner that provides for a degree of specificity to both taxpayers and the government. Taxpayers generally may plan their transactions in reliance on these rules to determine the federal income tax consequences arising from the transactions.

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of tax motivated transactions, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. Although these doctrines serve an important role in the administration of the tax system, invocation of these doctrines can be seen as at odds with an objective, "rule-based" system of taxation. Nonetheless, courts have applied the doctrines to deny tax benefits arising from certain transactions.[183]

A common-law doctrine applied with increasing frequency is the "economic substance" doctrine. In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax.[184]

Economic substance doctrine

Courts generally deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of tax considerations − notwithstanding that the purported activity actually occurred. The tax court has described the doctrine as follows:

The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to

[183] See, *e.g., ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999).

[184] Closely related doctrines also applied by the courts (sometimes interchangeable with the economic substance doctrine) include the "sham transaction doctrine" and the "business purpose doctrine". See, *e.g., Knetsch v. United States*, 364 U.S. 361 (1960) (denying interest deductions on a "sham transaction" whose only purpose was to create the deductions).

claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[185]

Business purpose doctrine

Another common law doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine. The business purpose test is a subjective inquiry into the motives of the taxpayer − that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[186]

Application by the courts

Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine.[187] Some courts apply a conjunctive test that requires a taxpayer to establish the presence of both economic substance (i.e., the objective component) and business purpose (i.e., the subjective component) in order for the transaction to survive judicial scrutiny.[188] A narrower approach used by some courts is to conclude that either a business purpose or economic substance is sufficient to respect the transaction).[189] A third approach regards economic

[185] *ACM Partnership v. Commissioner*, 73 T.C.M. at 2215.

[186] *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

[187] "The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify." *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988).

[188] See, *e.g., Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993) ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.").

[189] See, *e.g., Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists."); *IES Industries v. United States,* 253 F.3d 350, 358 (8th Cir. 2001) ("In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose out of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists (the economic substance test)."). As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied interchangeably. For a more detailed discussion of the sham transaction doctrine, see, *e.g.*, Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section*

substance and business purpose as "simply more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits.[190]

Profit potential

There also is a lack of uniformity regarding the necessity and level of profit potential necessary to establish economic substance. Since the time of *Gregory v. Helvering,*[191] several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.[192] In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.[193] Under this analysis, the taxpayer's profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the tax benefits.[194] In these cases, in assessing whether a reasonable possibility of profit exists, it is sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits.

3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters) (JCS-3-99) at 182.

[190] See, *e.g., ACM Partnership v. Commissioner*, 157 F.3d at 247; *James v. Commissioner*, 899 F.2d 905, 908 (10th Cir. 1995); *Sacks v. Commissioner*, 69 F.3d 982, 985 (9th Cir. 1995) ("Instead, the consideration of business purpose and economic substance are simply more precise factors to consider . . . We have repeatedly and carefully noted that this formulation cannot be used as a 'rigid two-step analysis'.").

[191] 293 U.S. 465 (1935).

[192] See, *e.g.*, *Knetsch*, 364 U.S. at 361; *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance); *Ginsburg v. Commissioner*, 35 T.C.M. (CCH) 860 (1976) (holding that a leveraged cattle-breeding program lacked economic substance).

[193] See, *e.g., Goldstein v. Commissioner*, 364 F.2d at 739-40 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); *Sheldon v. Commissioner*, 94 T.C. 738, 768 (1990) (stating, "potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions").

[194] See, *e.g., Rice's Toyota World v. Commissioner*, 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v. Commissioner,* 277 F.3d at 781 (applied the same test, *citing Rice's Toyota World*); *IES Industries v. United States*, 253 F.3d at 354 (the application of the objective economic substance test involves determining whether there was a "reasonable possibility of profit . . . apart from tax benefits.").

House Bill

No provision.

Senate Amendment

The Senate amendment clarifies and enhances the application of the economic substance doctrine. The Senate amendment provides that, in a case in which a court determines that the economic substance doctrine is relevant to a transaction (or a series of transactions), such transaction (or series of transactions) has economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.[195]

The Senate amendment does not change current law standards used by courts in determining when to utilize an economic substance analysis.[196] Also, the Senate amendment does not alter the court's ability to aggregate, disaggregate or otherwise recharacterize a transaction when applying the doctrine.[197] The Senate amendment provides a uniform definition of economic substance, but does not alter the flexibility of the courts in other respects.

Conjunctive analysis

The Senate amendment clarifies that the economic substance doctrine involves a conjunctive analysis − there must be an objective inquiry regarding the effects of the transaction on the taxpayer's economic position, as well as a subjective inquiry regarding the taxpayer's motives for engaging in the transaction. Under the Senate amendment, a transaction must satisfy both tests − i.e., it must change in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and the taxpayer must have a substantial non-tax purpose for entering into such transaction (and the transaction is a reasonable means of accomplishing such purpose) − in order to satisfy the economic substance doctrine. This clarification eliminates the disparity that exists among the circuits regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic

[195] If the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this provision.

[196] See, *e.g.*, Treas. Reg. sec. 1.269-2, stating that characteristic of circumstances in which a deduction otherwise allowed will be disallowed are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate.

[197] See, *e.g., Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path.").

position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.

<u>Non-tax business purpose</u>

The Senate amendment provides that a taxpayer's non-tax purpose for entering into a transaction (the second prong in the analysis) must be "substantial," and that the transaction must be "a reasonable means" of accomplishing such purpose. Under this formulation, the non-tax purpose for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities.[198]

In determining whether a taxpayer has a substantial non-tax business purpose, an objective of achieving a favorable accounting treatment for financial reporting purposes will not be treated as having a substantial non-tax purpose.[199] Furthermore, a transaction that is expected to increase financial accounting income as a result of generating tax deductions or losses without a corresponding financial accounting charge (i.e., a permanent book-tax difference)[200] should not

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[198] See, *e.g.*, Treas. Reg. sec. 1.269-2(b) (stating that a distortion of tax liability indicating the principal purpose of tax evasion or avoidance might be evidenced by the fact that "the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer"). Similarly, in *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189 (1997), the court stated:

> Key to [the determination of whether a transaction has economic substance] is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. [citations omitted]

See also Martin McMahon Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, 94 Tax Notes 1017, 1023 (Feb. 25, 2002) (advocates "confining the most rigorous application of business purpose, economic substance, and purposive activity tests to transactions outside the ordinary course of the taxpayer's business -- those transactions that do not appear to contribute to any business activity or objective that the taxpayer may have had apart from tax planning but are merely loss generators."); Mark P. Gergen, *The Common Knowledge of Tax Abuse,* 54 SMU L. Rev. 131, 140 (Winter 2001) ("The message is that you can pick up tax gold if you find it in the street while going about your business, but you cannot go hunting for it.").

[199] However, if the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, such tax benefits should not be disallowed solely because the transaction results in a favorable accounting treatment. An example is the repealed foreign sales corporation rules.

[200] This includes tax deductions or losses that are anticipated to be recognized in a period subsequent to the period the financial accounting benefit is recognized. For example, FAS 109 in some cases permits the recognition of financial accounting benefits prior to the period in which the tax benefits are recognized for income tax purposes.

be considered to have a substantial non-tax purpose unless a substantial non-tax purpose exists apart from the financial accounting benefits.[201]

By requiring that a transaction be a "reasonable means" of accomplishing its non-tax purpose, the Senate amendment reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[202]

Profit potential

Under the Senate amendment, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position; the proposal merely sets forth a minimum threshold of profit potential if that test is relied on to demonstrate a meaningful change in economic position. If a taxpayer relies on a profit potential, however, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.[203] Moreover, the profit potential must exceed a risk-free rate of return. In addition, in determining pre-tax profit, fees and other transaction expenses and foreign taxes are treated as expenses.

In applying the profit potential test to a lessor of tangible property, depreciation, applicable tax credits (such as the rehabilitation tax credit and the low income housing tax credit), and any other deduction as provided in guidance by the Secretary are not taken into account in measuring tax benefits.

Transactions with tax-indifferent parties

The Senate amendment also provides special rules for transactions with tax-indifferent parties. For this purpose, a tax-indifferent party means any person or entity not subject to Federal income tax, or any person to whom an item would have no substantial impact on its income tax liability. Under these rules, the form of a financing transaction will not be respected if the present value of the tax deductions to be claimed is substantially in excess of the present

[201] Claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement. See, *e.g., American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'") (citing *Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)).

[202] See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

[203] Thus, a "reasonable possibility of profit" will not be sufficient to establish that a transaction has economic substance.

value of the anticipated economic returns to the lender. Also, the form of a transaction with a tax-indifferent party will not be respected if it results in an allocation of income or gain to the tax-indifferent party in excess of the tax-indifferent party's economic gain or income or if the transaction results in the shifting of basis on account of overstating the income or gain of the tax-indifferent party.

Other rules

The Secretary may prescribe regulations which provide (1) exemptions from the application of the proposal, and (2) other rules as may be necessary or appropriate to carry out the purposes of the proposal.

No inference is intended as to the proper application of the economic substance doctrine under present law. In addition, except with respect to the economic substance doctrine, the bill shall not be construed as altering or supplanting any other common law doctrine (including the sham transaction doctrine), and the Senate amendment shall be construed as being additive to any such other doctrine.

Effective date.−The Senate amendment applies to transactions entered into after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

20. Penalty for understatements attributable to transactions lacking economic substance, etc. (sec. 5522 of the Senate amendment)

Present Law

General accuracy-related penalty

An accuracy-related penalty under section 6662 applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 (or, in the case of corporations, by the lesser of (a) 10 percent of the correct tax (or $10,000 if greater) or (b) $10 million), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[204] Except in the case of tax shelters,[205] the amount of any understatement is

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[204] Sec. 6662.

[205] A tax shelter is defined for this purpose as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, other entity, plan, or arrangement is the avoidance or evasion of Federal income tax. Sec. 6662(d)(2)(C).

reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. The Treasury Secretary may prescribe a list of positions which the Secretary believes do not meet the requirements for substantial authority under this provision.

The section 6662 penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[206] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[207]

Listed transactions and reportable avoidance transactions

In general

A separate accuracy-related penalty under section 6662A applies to "listed transactions" and to other "reportable transactions" with a significant tax avoidance purpose (hereinafter referred to as a "reportable avoidance transaction"). The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

Both listed transactions and reportable transactions are allowed to be described by the Treasury department under section 6707A(c), which imposes a penalty for failure adequately to report such transactions under section 6011. A reportable transaction is defined as one that the Treasury Secretary determines is required to be disclosed because it is determined to have a potential for tax avoidance or evasion.[208] A listed transaction is defined as a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of the reporting disclosure requirements.[209]

Disclosed transactions

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction.[210]

[206] Sec. 6664(c).

[207] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

[208] Sec. 6707A(c)(1).

[209] Sec. 6707A(c)(2).

[210] Sec. 6662A(a).

The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the "strengthened reasonable cause exception"), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

Undisclosed transactions

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a strict-liability penalty generally applies), and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.[211] However, a taxpayer will be treated as having adequately disclosed a transaction for this purpose if the IRS Commissioner has separately rescinded the separate penalty under section 6707A for failure to disclose a reportable transaction.[212] The IRS Commissioner is authorized to do this only if the failure does not relate to a listed transaction and only if rescinding the penalty would promote compliance and effective tax administration.[213]

A public entity that is required to pay a penalty for an undisclosed listed or reportable transaction must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear; and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).[214]

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this provision, the amount of the understatement is determined as the sum of: (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return);[215] and (2) the amount of

[211] Sec. 6662A(c).

[212] Sec. 6664(d).

[213] Sec. 6707A(d).

[214] Sec. 6707A(e).

[215] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without

any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

Except as provided in regulations, a taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.[216]

Strengthened reasonable cause exception

A penalty is not imposed under the provision with respect to any portion of an understatement if it is shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires: (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011;[217] (2) that there is or was substantial authority for such treatment; and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief: (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed; and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.[218]

A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion (1) is provided by a "disqualified tax advisor" or (2) is a "disqualified opinion."

Disqualified tax advisor

A disqualified tax advisor is any advisor who: (1) is a material advisor[219] and who participates in the organization, management, promotion or sale of the transaction or is related

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regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income. Sec. 6662A(b).

[216] Sec. 6662A(e)(3).

[217] See the previous discussion regarding the penalty for failing to disclose a reportable transaction.

[218] Sec. 6664(d).

[219] The term "material advisor" means any person who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons ($250,000 in any other case). Sec. 6111(b)(1).

(within the meaning of section 267(b) or 707(b)(1)) to any person who so participates; (2) is compensated directly or indirectly[220] by a material advisor with respect to the transaction; (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained; or (4) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents: (1) establishing a structure used in connection with the transaction (such as a partnership agreement); (2) describing the transaction (such as an offering memorandum or other statement describing the transaction); or (3) relating to the registration of the transaction with any federal, state or local government body.[221] Participation in the "management" of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

An opinion may not be relied upon if the opinion: (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events); (2) unreasonably relies upon representations, statements, finding or agreements of the taxpayer or any other person; (3) does not identify and consider all relevant facts; or (4) fails to meet any other requirement prescribed by the Secretary.

Coordination with other penalties

To the extent a penalty on an understatement is imposed under section 6662A, that same amount of understatement is not also subject to the accuracy-related penalty under section 6662(a) or to the valuation misstatement penalties under section 6662(e) or 6662(h). However, such amount of understatement is included for purposes of determining whether any

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[220] This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

[221] An advisor should not be treated as participating in the organization of a transaction if the advisor's only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a "disqualified tax advisor" with respect to the transaction if the advisor participates in the management, promotion or sale of the transaction (or if the advisor is compensated by a material advisor, has a fee arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary, has a continuing financial interest with respect to the transaction).

understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1) and for purposes of identifying an underpayment under the section 6663 fraud penalty.

The penalty imposed under section 6662A does not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

House Bill

No provision.

Senate Amendment

The Senate amendment imposes a penalty for an understatement attributable to any transaction that lacks economic substance (referred to in the statute as a "non-economic substance transaction understatement").[222] The penalty rate is 40 percent (reduced to 20 percent if the taxpayer adequately discloses the relevant facts in accordance with regulations prescribed under section 6011). No exceptions (including the reasonable cause or rescission rules) to the penalty are available (i.e., the penalty is a strict-liability penalty).

A "non-economic substance transaction" means any transaction if (1) the transaction lacks economic substance (as defined in the earlier proposal regarding the economic substance doctrine),[223] (2) the transaction was not respected under the rules relating to transactions with tax-indifferent parties (as described in the immediately preceding proposal regarding the economic substance doctrine),[224] or (3) any similar rule of law. For this purpose, a similar rule of law would include, for example, an understatement attributable to a transaction that is determined to be a sham transaction.

For purposes of the Senate amendment, the calculation of an "understatement" is made in the same manner as in the present law provision relating to accuracy-related penalties for listed and reportable avoidance transactions (sec. 6662A). Thus, the amount of the understatement under the proposal would be determined as the sum of (1) the product of the highest corporate or

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[222] Thus, unlike the present-law accuracy-related penalty under section 6662A (which applies only to listed and reportable avoidance transactions), the new penalty under this provision applies to any transaction that lacks economic substance.

[223] The Senate amendment generally provides that in any case in which a court determines that the economic substance doctrine is relevant, a transaction has economic substance only if: (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose. Specific other rules also apply. See "Senate Amendment" for the immediately preceding provision, "Clarification of the economic substance doctrine."

[224] The Senate amendment provides that the form of a transaction that involves a tax-indifferent party will not be respected in certain circumstances.

individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return),[225] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. In essence, the penalty will apply to the amount of any understatement attributable solely to a non-economic substance transaction.

As in the case of the understatement penalty for reportable and listed transactions under present law section 6662A(e)(3), except as provided in regulations, the taxpayer's treatment of an item will not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted regarding an examination of such return or such other date as specified by the Secretary.

As in the case of the understatement penalty for undisclosed reportable transactions under present law section 6707A, a public entity that is required to pay a penalty under the provision (but in this case, regardless of whether the transaction was disclosed) must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Regardless of whether the transaction was disclosed, once a penalty under the Senate amendment has been included in the first letter of proposed deficiency which allows the taxpayer an opportunity for administrative review in the IRS Office of Appeals, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally. Furthermore, the IRS is required to keep records summarizing the application of this penalty and providing a description of each penalty compromised under the proposal and the reasons for the compromise.

Any understatement on which a penalty is imposed under the provision will not be subject to the accuracy-related penalty under section 6662 or under 6662A (accuracy-related penalties for listed and reportable avoidance transactions). However, an understatement under the Senate amendment is taken into account for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1). The penalty imposed under the Senate amendment will not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

Effective date.−The Senate amendment applies to transactions entered into after the date of enactment.

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[225] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses that would (without regard to section 1211) be allowed for such year, would be treated as an increase in taxable income.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

21. Denial of deduction for interest on underpayments attributable to noneconomic substance transactions (sec. 5523 of the Senate amendment)

Present Law

No deduction for interest is allowed for interest paid or accrued on any underpayment of tax which is attributable to the portion of any reportable transaction understatement with respect to which the relevant facts were not adequately disclosed.[226] The Secretary of the Treasury is authorized to define reportable transactions for this purpose.[227]

House Bill

No provision.

Senate Amendment

The Senate amendment extends the disallowance of interest deductions to interest paid or accrued on any underpayment of tax which is attributable to any noneconomic substance underpayment (whether or not disclosed).

Effective date.−The Senate amendment applies to transactions after the date of enactment in taxable years ending after such date.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

22. Waiver of user fee for installment agreements using automated withdrawals (sec. 5531 of the Senate amendment)

Present Law

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed.[228]

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[226] Sec. 162(m). Under section 6664(d)(2)(A), in such a case of nondisclosure, the taxpayer also is not entitled to the "reasonable cause and good faith" exception to the section 6662A penalty for a reportable transaction understatement.

[227] See the description of present law under the immediately preceding proposal, "Penalty for understatements attributable to transactions lacking economic substance, etc."

[228] Sec. 6159.

An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

The IRS charges a $43 user fee if a request for an installment agreement is approved.

House Bill

No provision.

Senate Amendment

The Senate amendment waives the user fee for installment agreements in which the parties agree to the use of automated installment payments (such as automated debits from a bank account).

Effective date.−The Senate amendment applies to agreements entered into on or after the date which is 180 days after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

23. Termination of installment agreements (sec. 5532 of the Senate amendment)

Present Law

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments, if the IRS determines that doing so will facilitate collection of the amounts owed.[229] An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

Under present law, the IRS is permitted to terminate an installment agreement only if: (1) the taxpayer fails to pay an installment at the time the payment is due; (2) the taxpayer fails to pay any other tax liability at the time when such liability is due; (3) the taxpayer fails to provide a financial condition update as required by the IRS; (4) the taxpayer provides inadequate or incomplete information when applying for an installment agreement; (5) there has been a

[229] Sec. 6159.

significant change in the financial condition of the taxpayer; or (6) the collection of the tax is in jeopardy.[230]

House Bill

No provision.

Senate Amendment

The Senate amendment grants the IRS authority to terminate installment agreement when a taxpayer fails to timely make a required Federal tax deposit or fails to timely file a tax return (including extensions). Under the Senate amendment, the IRS may terminate an installment agreement even if the taxpayer remained current with payments under the installment agreement.

Effective date.−The Senate amendment is effective for failures occurring on or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

24. Office of Chief Counsel review of offers-in-compromise (sec. 5533 of the Senate amendment)

Present Law

The IRS has the authority to settle a tax debt pursuant to an offer-in-compromise. IRS regulations provide that such offers can be accepted if the taxpayer is unable to pay the full amount of the tax liability and it is doubtful that the tax, interest, and penalties can be collected or there is doubt as to the validity of the actual tax liability. Offers to compromise tax liabilities of $50,000 or more can only be accepted if the reasons for the acceptance are documented in detail and supported by a written opinion from the IRS Chief Counsel.[231]

House Bill

No provision.

Senate Amendment

The Senate amendment repeals the requirement that offers to compromise liabilities of $50,000 or more must be supported by a written opinion from the IRS Chief Counsel. Under the Senate amendment, written opinions must only be provided if the Secretary determines that an opinion is required with respect to a compromise.

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[230] Sec. 6159(b)(2), (3), and (4).

[231] Sec. 7122.

<u>Effective date</u>.−The Senate amendment applies to offers-in-compromise submitted or pending on or after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

25. Partial payments required with submissions of offers-in-compromise (sec. 5534 of the Senate amendment)

Present Law

The IRS has the authority to compromise any civil or criminal case arising under the internal revenue laws.[232] In general, taxpayers initiate this process by making an offer-in-compromise, which is an offer by the taxpayer to settle an outstanding tax liability for less than the total amount due. The IRS currently imposes a user fee of $150 on most offers, payable upon submission of the offer to the IRS. Taxpayers may justify their offers on the basis of doubt as to collectibility or liability or on the basis of effective tax administration. In general, enforcement action is suspended during the period that the IRS evaluates an offer. In some instances, it may take the IRS 12 to 18 months to evaluate an offer.[233] Taxpayers are permitted (but not required) to make a deposit with their offer; if the offer is rejected, the deposit is generally returned to the taxpayer. There are two general categories[234] of offers-in-compromise, lump-sum offers and periodic payment offers. Taxpayers making lump-sum offers propose to make one lump-sum payment of a specified dollar amount in settlement of their outstanding liability. Taxpayers making periodic payment offers propose to make a series of payments over time (either short-term or long-term) in settlement of their outstanding liability.

House Bill

No provision.

Senate Amendment

The Senate amendment requires a taxpayer to make partial payments to the IRS while the taxpayer's offer is being considered by the IRS. For lump-sum offers, taxpayers must make a down payment of 20 percent of the amount of the offer with any application. For purposes of this provision, a lump-sum offer includes single payments as well as payments made in five or fewer installments. For periodic payment offers, the provision requires the taxpayer to comply

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[232] Sec. 7122.

[233] *Olsen v. United States*, 326 F. Supp. 2d 184 (D. Mass. 2004).

[234] The IRS categorizes payment plans with more specificity, which is generally not significant for purposes of the proposal. See Form 656, Offer in Compromise, page 6 of instruction booklet (revised July 2004).

with the taxpayer's own proposed payment schedule while the offer is being considered. Offers submitted to the IRS that do not comport with these payment requirements are returned to the taxpayer as unprocessable and immediate enforcement action is permitted. The provision eliminates the user fee requirement for offers submitted with the appropriate partial payment.

The Senate amendment also provides that an offer is deemed accepted if the IRS does not make a decision with respect to the offer within two years from the date the offer was submitted. With respect to offers submitted more than five years after the date of enactment, an offer is deemed accepted if the IRS does not make a decision with respect to the offer within 12 months of its submission.

Effective date.−The Senate amendment applies to offers-in-compromise submitted or pending on and after the date which is 60 days after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

26. Joint task force on offers-in-compromise (sec. 5535 of the Senate amendment)

Present Law

The IRS has the authority to compromise any civil or criminal case arising under the internal revenue laws.[235] In general, taxpayers initiate this process by making an offer-in-compromise, which is an offer by the taxpayer to settle an outstanding tax liability for less than the total amount due. The IRS currently imposes a user fee of $150 on most offers, payable upon submission of the offer to the IRS. Taxpayers may justify their offers on the basis of doubt as to collectibility or liability or on the basis of effective tax administration. In general, enforcement action is suspended during the period that the IRS evaluates an offer. Taxpayers are permitted (but not required) to make a deposit with their offer; if the offer is rejected, the deposit is generally returned to the taxpayer. There are two general categories[236] of offers-in-compromise, lump-sum offers and periodic payment offers. Taxpayers making lump-sum offers propose to make one lump-sum payment of a specified dollar amount in settlement of their outstanding liability. Taxpayers making periodic payment offers propose to make a series of payments over time (either short-term or long-term) in settlement of their outstanding liability.

House Bill

No provision.

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[235] Sec. 7122.

[236] The IRS categorizes payment plans with more specificity, which is generally not significant for purposes of the proposal. See Form 656, Offer in Compromise, page 6 of instruction booklet (revised July 2004).

Senate Amendment

The Senate amendment requires the Secretary to establish a joint task force to review the IRS's determinations with respect to offers-in-compromise, including offers which raise equitable, public policy, or economic hardship as grounds for compromising a tax liability. The task force shall consist of one representative each from the Department of Treasury, the IRS Oversight Board, the Office of Chief Counsel, the Office of the Taxpayer Advocate, the Office of Appeals, and the IRS office charged with operating the offer-in-compromise program. The task force is required to report annually to Congress regarding its findings and recommendations with respect to the offer-in-compromise program. The provision requires the filing of annual reports beginning in 2006.

Effective date.−The Senate amendment is effective on the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

O. Additional Revenue Provisions Relating to the Highway Trust Fund

1. Suspension of transfers from Highway Trust Fund for certain repayments and credits (sec. 5601 of the Senate amendment)

Present Law

Under sec. 9503(c)(2), certain transfers are made from the Highway Trust Fund to reimburse the General Fund, for amounts paid in respect of gasoline used on farms,[237] amounts paid in respect of gasoline used for certain nonhighway purposes or by local transit systems,[238] amounts relating to fuels not used for taxable purposes,[239] and income tax credits allowed with respect to the nontaxable uses of fuels.[240]

House Bill

No provision.

Senate Amendment

Section 9503(c)(2), relating to certain transfers from the Highway Trust Fund to the General Fund, is suspended between April 1, 2005 and October 1, 2005.

Effective date.−The Senate amendment applies to amounts paid for which no transfer has been made before April 1, 2005.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Dedicate gas guzzler tax to the Highway Trust Fund (sec. 5602 of the Senate amendment)

Present Law

Under present law, the Code imposes a tax ("the gas guzzler tax") on automobiles that are manufactured primarily for use on public streets, roads, and highways and that are rated at 6,000 pounds unloaded gross vehicle weight or less. The tax applies to limousines without regard to the weight requirement. The tax is imposed on the sale by the manufacturer of each automobile of a model type with a fuel economy of 22.5 miles per gallon or less. The tax range begins at

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[237] Sec. 6420.

[238] Sec. 6421.

[239] Sec. 6427.

[240] Sec. 34.

$1,000 and increases to $7,700 for models with a fuel economy less than 12.5 miles per gallon. Taxes imposed under this provision are deposited into the General Fund.

House Bill

No provision.

Senate Amendment

The Senate amendment temporarily dedicates the gas guzzler tax (as modified by the Senate amendment[241]) to the Highway Trust Fund. The Highway Trust Fund will be credited with gas guzzler taxes imposed on or after July 1, 2005 and before October 1, 2005.

Effective date.−The Senate amendment applies to taxes imposed on or after July 1, 2005.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Treatment of kerosene for use in aviation (sec. 5611 of the Senate amendment and secs. 4041, 4081, 4082, 6427, 9502, and 9503 of the Code)

Present Law

In general, aviation-grade kerosene is taxed at a rate of 21.8 cents per gallon upon removal of such fuel from a refinery or terminal (or entry into the United States) and on the sale of such fuel to any unregistered person unless there was a prior taxable removal or entry of such fuel.[242] Aviation-grade kerosene may be removed at a reduced rate, either 4.3 or zero cents per gallon, if the aviation fuel is removed directly into the fuel tank of an aircraft for use in commercial aviation[243] or for a use that is exempt from the tax imposed by section 4041(c) (other than by reason of a prior imposition of tax),[244] or is removed or entered as part of an exempt bulk transfer.[245] These taxes are credited to the Airport and Airway Trust Fund.[246] If taxed aviation-

[241] The Senate amendment repeals the tax as it applies to limousines rated at greater than 6,000 pounds unloaded gross vehicle weight.

[242] Sec. 4081(a)(2)(A)(iv). (An additional 0.1 cent is imposed on aviation-grade kerosene and credited to the Leaking Underground Storage Tank ("LUST" Trust Fund.) Sec. 4081(a)(2)(B). The LUST Trust Fund tax is set to expire after September 30, 2005. Sec. 4081(d)(3).

[243] Sec. 4081(a)(2)(C).

[244] Sec. 4082(e). Exempt uses include use in commercial aviation as supplies for vessels or aircraft, which includes use by certain foreign air carriers and for the international flights of domestic carriers, secs. 4082(e), 6427(l)(2), and 4221(d)(3).

[245] Sec. 4081(a)(1)(B).

grade kerosene is used for a nontaxable use, a claim for credit or refund may be made.[247] Such claims are paid from the Airport and Airway Trust Fund to the general fund of the Treasury.[248] All other removals and entries of kerosene used for surface transportation are taxed at the diesel tax rate of 24.3 cents per gallon,[249] and these taxes are credited to the Highway Trust Fund.[250] If aviation-grade kerosene is taxed upon removal or entry but fraudulently diverted for surface transportation, the taxes remain in the Airport and Airway Trust Fund, and the Highway Trust Fund is not credited for the taxes on such fuel.

A special rule of present law addresses whether a removal from a refueler truck, tanker, or tank wagon may be treated as a removal from a terminal for purposes of determining whether aviation-grade kerosene is removed directly into the wing of an aircraft for use in commercial aviation, and so eligible for the 4.3 cents per gallon rate.[251] For the special rule to apply, a qualifying truck, tanker, or tank wagon must be loaded with aviation-grade kerosene from a terminal: (1) that is located within a secured area of an airport, and (2) from which no vehicle licensed for highway use is loaded with aviation fuel, except in exigent circumstances identified by the Secretary in regulations. In order to qualify for the special rule, a refueler truck, tanker, or tank wagon must: (1) be loaded with fuel for delivery only into aircraft at the airport where the terminal is located; (2) have storage tanks, hose, and coupling equipment designed and used for the purposes of fueling aircraft; (3) not be registered for highway use; and (4) be operated by the terminal operator (who operates the terminal rack from which the fuel is unloaded) or by a person that makes a daily accounting to such terminal operator of each delivery of fuel from such truck, tanker, or tank wagon.

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[246] Sec. 9502(b)(1)(C).

[247] Sec. 6427(l)(1) and 6427(l)(4). Nontaxable uses include: (1) use other than as fuel in an aircraft (such as use in heating oil); (2) use on a farm for farming purposes; (3) use in a military aircraft owned by the United States or a foreign country; (4) use in a domestic air carrier engaged in foreign trade or trade between the United States and any of its possessions; (5) use in a foreign air carrier engaged in foreign trade or trade between the United States and any of its possessions (but only if the foreign carrier's country of registration provides similar privileges to United States carriers); (6) exclusive use of a State or local government; (7) sales for export, or shipment to a United States possession; (8) exclusive use by a nonprofit educational organization; (9) use by an aircraft museum exclusively for the procurement, care, or exhibition of aircraft of the type used for combat or transport in World War II, and (10) use as a fuel in a helicopter or a fixed-wing aircraft for purposes of providing transportation with respect to which certain requirements are met. Secs. 4041(f)(2), 4041(g), 4041(h), 4041(l), and 6427(l)(2)(B)(i).

[248] Sec. 9502(d)(2).

[249] Sec. 4081(a)(2)(iii).

[250] Sec. 9503(b)(1)(D).

[251] Sec. 4081(a)(3).

House Bill

No provision.

Senate Amendment

The Senate amendment imposes the kerosene tax rate of 24.3 cents per gallon upon the entry or removal of aviation-grade kerosene and on the sale of such fuel to any unregistered person unless there was a prior taxable removal or entry of the fuel. The present law reduced rates for removals of aviation-grade kerosene directly into the fuel tank of an aircraft apply,[252] except that in addition, under the proposal, if kerosene is removed directly into the fuel tank of an aircraft for use in aviation other than commercial aviation, the rate of tax is 21.8 cents per gallon.

The Senate amendment provides that amounts may be claimed as credits or refunds for kerosene that is taxed at the 24.3 cents per gallon rate and used for aviation purposes. If kerosene is used for noncommercial aviation, the amount is 2.5 cents; if kerosene is used for commercial aviation, the amount is 20 cents; if kerosene is used for a use that is exempt from tax (as determined under present law), the amount is 24.3 cents. Present law rules with respect to claims apply, except for claims with respect to kerosene used in noncommercial aviation, which may be claimed by the ultimate vendor. To be eligible to receive a payment, a vendor must be registered and must show either that the price of the fuel did not include the tax and the tax was not collected from the purchaser, the amount of tax was repaid to the ultimate purchaser, or the written consent of the purchaser to the making of the claim was filed with the Secretary.

Under the Senate amendment, all taxes collected at the 24.3 cents per gallon rate (under section 4081) initially are credited to the Highway Trust Fund. The Senate amendment requires the Secretary to transfer from time to time from the Highway Trust Fund into the Airport and Airway Trust Fund amounts equivalent to the taxes received under sections 4041 and 4081 with respect to fuels used in a nontaxable use to the extent such amounts exceed the amounts paid with respect to such use. Transfers are required to be made with respect to taxes received on or after October 1, 2005, and before October 1, 2011.

Effective date.–The Senate amendment is effective for fuels or liquids removed, entered, or sold after September 30, 2005.

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[252] For example, for kerosene removed directly into the fuel tank of an aircraft for use in commercial aviation by a person registered for such use, the rate of tax is 4.3 cents per gallon. Kerosene removed directly into the fuel tank of an aircraft for an exempt use is not taxed. For purposes of these reduced rates, it is intended that the following airports be included on the Secretary's list of airports that include a secured area in which a terminal is located. The airports are listed by airport name, and the terminal with respect to the airport is identified by terminal control number: Los Angeles International Airport (T-95-CA-4812) and Federal Express Corporation Memphis Airport (T-62-TN-2220).

Conference Agreement

The conference agreement follows the Senate amendment with the following modifications.

The conference agreement provides that the rate of tax on kerosene is 21.8 cents per gallon if the kerosene is removed from refueler trucks, tankers, and tank wagons that are loaded with fuel from a terminal that is located in an airport, without regard to whether the terminal is located in a secured area of the airport, as long as all the other requirements of the present law special rule related to such trucks, tankers, and wagons are met. The conference agreement clarifies that the rate of tax upon removal of kerosene is zero if the removal is from a refueler truck, tanker, or tank wagon that meets all of the requirements of present law, including the security requirement, the kerosene is delivered directly into the fuel tank of an aircraft, and the kerosene is exempt from the tax imposed by section 4041(c) (other than by prior imposition of tax).

The Senate amendment is clarified to provide that claims for payment for kerosene that is used for noncommercial aviation may be claimed by the ultimate vendor only.

The conference agreement clarifies the transfer mechanism for payments from the Highway Trust Fund to the Airport and Airway Trust Fund to provide that such transfers shall be made monthly in amounts equivalent to 21.8 cents per gallon for claims made with respect to kerosene used for noncommercial aviation purposes, 4.3 cents per gallon for claims made with respect to kerosene used for commercial aviation purposes, and the amounts attributable to taxes received with respect to amounts allowed as a credit under section 34 for kerosene used for aviation purposes. The conference agreement requires that transfers be made on the basis of estimates by the Secretary, with proper adjustments to be made subsequently to the extent prior estimates were in excess of or less than the amounts required to be transferred. The conference agreement clarifies that the Airport and Airway Trust Fund does not reimburse the General Fund for claims with respect to kerosene that is taxed at the 24.3 cents per gallon rate and used for aviation purposes, or with respect to credits allowed under section 34 to the extent the Highway Trust Fund is credited initially with the amount of tax with respect to which the credit is claimed.

4. Repeal of ultimate vendor refund claims with respect to farming (sec. 5612 of the Senate amendment and sec. 6427(l) of the Code)

Present Law

In general - ultimate purchaser refunds for nontaxable uses

In general, the Code provides that if diesel fuel or kerosene on which tax has been imposed is used by any person in a nontaxable use, the Secretary is to refund (without interest) to the ultimate purchaser the amount of tax imposed.[253] The refund is made to the ultimate

[253] Sec. 6427(l)(1).

purchaser of the taxed fuel by either income tax credit or refund payment.[254] Not more than one claim may be filed by any person with respect to fuel used during its taxable year. However, there are exceptions to this rule.

An ultimate purchaser may make a claim for a refund payment for any quarter of a taxable year for which the purchaser can claim at least $750.[255] If the purchaser cannot claim at least $750 at the end of quarter, the amount can be carried over to the next quarter to determine if the purchaser can claim at least $750. If the purchaser cannot claim at least $750 at the end of the taxable year, the purchaser must claim a credit on the person's income tax return.

As discussed below, these ultimate purchaser refund rules do not apply to diesel fuel or kerosene used on a farm. The Code precludes the ultimate purchaser from claiming a refund for such use. Instead, the refund claims are made by registered vendors as described below.

Special vendor rule for use on a farm for farming purposes

In the case of diesel fuel or kerosene used on a farm for farming purposes refund payments are paid to the ultimate, registered vendors ("registered ultimate vendor") of such fuels. Thus a registered ultimate vendor that sells undyed diesel fuel or undyed kerosene to any of the following may make a claim for refund: (1) the owner, tenant, operator of a farm for use by that person on a farm for farming purposes; and (2) a person other than the owner, tenant, or operator of a farm for use by that person on a farm in connection with cultivating, raising or harvesting. The registered ultimate vendor is the only person who may make the claim with respect to diesel fuel or kerosene used on a farm for farming purposes. The purchaser of the fuel cannot make the claim for refund.

Registered ultimate vendors may make weekly claims if the claim is at least $200 ($100 or more in the case of kerosene).[256] If not paid within 45 days (20 days for an electronic claim), the Secretary is to pay interest on the claim.

House Bill

No provision.

Senate Amendment

The Senate amendment repeals ultimate vendor refund claims in the case of diesel fuel or kerosene used on a farm for farming purposes. Thus, refunds for taxed diesel fuel or kerosene

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[254] Generally, refund payments are only made to governmental units and tax-exempt organizations. Sec. 6427(k). The quarterly payment claim rules for ultimate purchasers are an exception to this rule.

[255] Sec. 6427(i)(2).

[256] Sec. 6427(i)(4)(A).

used on a farm for farming purposes would be paid to the ultimate purchaser under the rules applicable to nontaxable uses of diesel fuel or kerosene.

Effective date.−The Senate amendment is effective for sales after September 30, 2005.

Conference Agreement

The conference agreement follows the Senate amendment.

5. Refunds of excise taxes on exempt sales of taxable fuel by credit card (sec. 5613 of the Senate amendment and secs. 6206, 6416, 6427, and 6675 of the Code)

Present Law

Under the rules in effect prior to 2005, in the case of gasoline on which tax had been paid and sold to a State or local government, to a nonprofit educational organization, for supplies for vessels or aircraft, for export, or for the production of special fuels, the wholesale distributor that sold such gasoline was treated as the only person who paid the tax and thereby was the proper claimant for a credit or refund of the tax paid. A "wholesale distributor" included any person, other than an importer or producer, who sold gasoline to producers, retailers, or to users who purchased in bulk quantities and accepted delivery into bulk storage tanks. A wholesale distributor also included any person who made retail sales of gasoline at 10 or more retail motor fuel outlets.

Under a special administrative exception to these rules, a sale of gasoline charged on an oil company credit card issued to an exempt person described above is not considered a direct sale by the person actually selling the gasoline to the ultimate purchaser if the seller receives a reimbursement of the tax from the oil company (or indirectly through an intermediate vendor). Thus, the person that actually paid the tax, in most cases the oil company, is treated as the only person eligible to make the refund claim.[257]

The American Jobs Creation Act of 2004 ("AJCA")[258] modified the pre-existing statutory rules with respect to certain sales. Under AJCA, if a registered ultimate vendor purchases any gasoline on which tax has been paid and sells such gasoline to a State or local government or to a nonprofit educational organization, for its exclusive use, such ultimate vendor is treated as the only person who paid the tax and thereby is the proper claimant for a credit or refund of the tax

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[257] Notice 89-29, 1989-1 C.B. 669.

[258] Pub. L. No. 108-357.

paid.[259] However, AJCA did not change the special administrative oil company credit card rule described above.[260]

In addition, under AJCA, refund claims made by such an ultimate vendor may be filed for any period of at least one week for which $200 or more is payable. Any such claim must be filed on or before the last day of the first quarter following the earliest quarter included in the claim. The Secretary must pay interest on refunds unpaid after 45 days. If the refund claim was filed by electronic means, and the ultimate vendor has certified to the Secretary for the most recent quarter of the taxable year that all ultimate purchasers of the vendor are certified for highway exempt use as a State or local government or a nonprofit educational organization, refunds unpaid after 20 days must be paid with interest.[261]

In the case of diesel fuel or kerosene used in a nontaxable use, the ultimate purchaser is generally the only person entitled to claim a refund of excise tax.[262] However, in the case of diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, aviation-grade kerosene, and certain nonaviation-grade kerosene, an ultimate vendor may claim the refund if the ultimate vendor is registered and bears the tax (or receives the written consent of the ultimate purchaser to claim the refund).[263]

House Bill

No provision.

Senate Amendment

The Senate amendment replaces the oil company credit card rule with a new set of rules applicable to certain credit card sales. The new rules apply to all taxable fuels. Under the Senate amendment, if a purchase of taxable fuel is made by means of a credit card issued to an ultimate purchaser that is either a State or local government or, in the case of gasoline, a nonprofit educational organization, for its exclusive use, a credit card issuer who is registered and who extends such credit to the ultimate purchaser with respect to such purchase shall be the only person entitled to apply for a credit or refund if the following two conditions are met: (1) such registered person has not collected the amount of the tax from the purchaser, or has obtained the

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[259] AJCA, sec. 865(a), effective January 1, 2005. See Code sec. 6416(a)(4)(A).

[260] In Notice 2005-4, 2005-2 I.R.B. 289, the Treasury Department confirmed that it would continue to apply the oil company credit card rule until March 1, 2005. On February 28, 2005, the Treasury Department issued Notice 2005-24, 2005-12 I.R.B. 1, modifying Notice 2005-4. Notice 2005-24 stated that the oil company credit card rule will remain in effect until it is modified by a statutory change or by future guidance.

[261] Sec. 6146(a)(4)(B).

[262] Sec. 6427(l)(1).

[263] See sec. 6427(l)(4)(B), (l)(5)(B), and (l)(5)(C), and sec. 6416(a)(1)(A), (B), and (D).

written consent of the ultimate purchaser to the allowance of the credit or refund; and (2) such registered person has either repaid or agreed to repay the amount of the tax to the ultimate vendor, has obtained the written consent of the ultimate vendor to the allowance of the credit or refund, or has otherwise made arrangements that directly or indirectly provide the ultimate vendor with reimbursement of such tax. It is anticipated that such indirect arrangements may consist of the contractual undertaking of the relevant oil company to the credit card issuer that it will pay the amount of the tax to the ultimate vendor, and the corresponding contractual undertaking of the oil company to the ultimate vendor.

A credit card issuer entitled to claim a refund under the provision is responsible for collecting and supplying all the appropriate documentation currently required from ultimate vendors. The present-law refund amount and timing rules applicable to ultimate vendors, including the special rules for electronic claims, apply to refunds to credit card issuers under the provision.[264]

The Senate amendment also conforms present-law penalty provisions to the new rules.

The Senate amendment does not change the present-law rules applicable to non-credit card purchases.

Effective date.–The Senate amendment is effective for sales after December 31, 2005.

Conference Agreement

The conference agreement follows the Senate amendment with the following modifications.

Under the conference agreement, if a credit card issuer is not registered, or if either condition (1) or (2) described above is not met (or if the ultimate purchaser is not exempt), then the credit card issuer is required to collect an amount equal to the tax from the ultimate purchaser and only an (exempt) ultimate purchaser may claim a credit or payment from the IRS.[265] The conferees intend that tax-paid fuel shall not be sold tax free to an exempt entity by means of a credit card unless the credit card issuer is registered. An unregistered credit card issuer that does not collect an amount equal to the tax from the exempt entity is liable for present-law penalties for failure to register.[266] The present-law regulatory authority of the Secretary to prescribe the form, manner, terms, conditions of registration, and conditions of use of registration extends to registration under this provision.[267] Such authority may include rules that preclude persons

[264] See sec. 6416(a)(4)(B). Present law would continue to apply to the timing of ultimate purchaser claims. Under present law, claims by an ultimate purchaser are generally made on an annual basis. However, claims aggregating over $750 may be made quarterly. See secs. 6421(d) and 6427(i)(2).

[265] See sec. 6421(c).

[266] See secs. 6719, 7232, and 7272.

[267] Sec. 4101(a)(1).

which are registered credit card issuers from issuing nonregistered credit cards.[268] The conferees also intend that the IRS will review the registration of a registered credit card issuer that has engaged in multiple or flagrant violations of the requirements of the provision.

6. Recertification of exempt status (sec. 5614 of the Senate amendment)

Present Law

If gasoline is sold to any person for an exempt use, an ultimate purchaser that has borne the tax is entitled to claim a refund.[269] However, a registered ultimate vendor is the appropriate person to claim a refund of Federal excise taxes on gasoline sold to a State or local government or to a nonprofit educational organization.[270]

In general, in order to claim a refund of Federal excise taxes on gasoline (and on other articles subject to manufacturers excise taxes under Chapter 32 of the Code) sold to a State or local government or to a nonprofit educational organization, for its exclusive use, a claimant must submit a statement indicating that it possesses evidence of the exempt use giving rise to the overpayment of tax.[271] Such evidence consists of a certificate executed and signed by the ultimate purchaser, and must identify the article, show the name and address of the ultimate purchaser, and state the exempt use made or to be made of the article. In the case where the certificate sets forth the use to be made of the article, rather than its actual use, it must show that the ultimate purchaser has agreed to notify the claimant if the article is not in fact used as specified in the certificate.[272]

However, if the article to which the claim relates has passed through a chain of sales from the claimant to the ultimate purchaser, a certificate executed and signed by the ultimate vendor is sufficient to document the exempt use. The ultimate vendor certificate must contain the exempt sales information, and a statement that it possesses the ultimate purchaser certificates and will forward them to the claimant within three years from the date of the statement. An ultimate vendor statement may be made covering no more than 12 consecutive calendar quarters.[273]

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[268] Because registration occurs at the "person" (legal entity) level, it is anticipated that a credit card issuer will use a separate (registered) entity for the issuance of credit cards entitled to the benefits of this provision.

[269] Sec. 6421(c).

[270] Sec. 6416(a)(4)(A).

[271] Treas. Reg. sec. 48.6416(b)(2)-3(a)(5).

[272] Treas. Reg. sec. 48.6416(b)(2)-3(b)(1)(i) and (ii). The certificate must also contain a statement that the ultimate purchaser understands that it and any other party may, for fraudulent use of the certificate, be subject under section 7201 to a fine of not more than $10,000, or imprisonment for not more than 5 years, or both, together with the costs of prosecution.

[273] Treas. Reg. sec. 48.6416(b)(2)-3(b)(1)(i) and (iii).

In general, an ultimate purchaser is the proper party to claim a refund of Federal excise tax on diesel fuel or kerosene used by any person in a nontaxable use.[274] However, in the case of diesel or kerosene used by a State or local government, the ultimate vendor is the proper person if such vendor is registered and has borne the tax (or receives the written consent of the ultimate purchaser to claim the refund).[275] A registered ultimate vendor claiming a refund under this provision must provide a statement that it has in its possession an unexpired exemption certificate of the purchaser and that the claimant has no reason to believe any information in the certificate is false.[276]

A State or local government includes any political subdivision of a State, or the District of Columbia.[277] A nonprofit educational organization means an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on, and which either is exempt from income tax under section 501(a) or is a school operated as an activity of an organization described in section 501(c)(3) which is exempt from income tax under section 501(a).[278]

House Bill

No provision.

Senate Amendment

Under the Senate amendment, additional documentation requirements are imposed with respect to purchases of taxable fuel and certain other articles on a nontaxable basis by State or local governments and nonprofit educational organizations and with respect to refunds or credits by any person with respect to such purchases. The Senate amendment covers Federal excise taxes on sales of liquids for use as a fuel (including taxable fuels), compressed natural gas (except if sold for use on school buses or intracity buses), heavy trucks and trailers, recreational equipment (bows and arrows, sport fishing equipment and firearms), and tires (except for tires sold for use on qualified buses). The Senate amendment does not cover Federal excise taxes on sales of coal and vaccines.

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[274] Sec. 6427(l)(1). In the case of diesel fuel or kerosene, a nontaxable use is any use which is exempt from the tax imposed by section 4041(a)(1) other than by reason of a prior imposition of tax. Sec. 6427(l)(2).

[275] Sec. 6427(l)(5)(C).

[276] Treas. Reg. sec. 48.6427-9(e)(1)(vi).

[277] Sec. 4221(d)(4); Treas. Reg. sec. 48.6416(b)(2)-2(d).

[278] Sec. 4221(d)(5); Treas. Reg. sec. 48.6416(b)(2)-2(e).

In addition to present-law documentation requirements, in order for a State or local governmental entity to claim exemption from tax on sales of such covered articles, or for any person to claim a credit or refund based upon the State or local governmental status of the purchaser of such articles, the State must certify that the article is sold to a State or local government for the exclusive use of a State or local government. In the case of articles sold to a qualified volunteer fire department, as defined in section 150(e)(2),[279] the State must so certify, and the article must be sold for the exclusive use of the qualified volunteer fire department.

In order for a nonprofit educational organization to claim exemption from tax on such articles, or for any person to claim a credit or refund of tax on such articles based upon the nonprofit educational status of an organization, the State in which such organization is providing educational services must certify that such organization is in good standing.

For purposes of this provision, an Indian tribal government is treated as a State.[280] Consequently, it is intended that the applicable Indian tribal government will provide the certifications under this provision.

It is intended that the certifications required under this provision will be provided by exempt purchasers to the refund claimants (in addition to documentation required under present law), and that the IRS may require that such certifications be submitted as part of the claims. The Secretary may prescribe forms for such certifications.

Effective date.–The Senate amendment is effective for all sales after December 31, 2005.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

7. Reregistration in event of change in ownership (sec. 5615 of the Senate amendment and secs. 4101, 6719, 7232, and 7272 of the Code)

Present Law

Blenders, enterers, pipeline operators, position holders, refiners, terminal operators, and vessel operators are required to register with the Secretary with respect to fuels taxes imposed by sections 4041(a)(1) and 4081.[281] An assessable penalty for failure to register is $10,000 for each

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[279] In general, as defined in section 150(e)(2), a qualified volunteer fire department is any organization organized and operated to provide firefighting or emergency medical services for persons in an area that is not provided with any other firefighting services, and which is required by written agreement with the political subdivision to furnish firefighting services in such area.

[280] See sec. 7871(a)(2). Section 7871(b) provides that in order for an excise tax exemption (with respect to chapter 31 or 32) to apply to an Indian tribal government, the transaction must involve the exercise of an essential governmental function of the Indian tribal government.

[281] Sec. 4101; Treas. Reg. secs. 48.4101-1(a) and 48.4101-1(c)(1).

initial failure, plus $1,000 per day that the failure continues.[282] A non-assessable penalty for failure to register is $10,000.[283] A criminal penalty of $10,000, or imprisonment of not more than five years, or both, together with the costs of prosecution also applies to a failure to register and to certain false statements made in connection with a registration application.[284] Treasury regulations require that a registrant notify the Secretary of any change (such as a change in ownership) in the information a registrant submitted in connection with its application for registration within 10 days of the change.[285] The Secretary has the discretion to revoke the registration of a noncompliant registrant.

House Bill

No provision.

Senate Amendment

The Senate amendment requires that upon a change in ownership of a registrant, the registrant must reregister with the Secretary, as provided by the Secretary. A change in ownership means that after a transaction (or series of related transactions), more than 50 percent of the ownership interests in, or assets of, a registrant are held by persons other than persons (or persons related thereto) who held more than 50 percent of such interests or assets before the transaction (or series of related transactions). The provision does not apply to companies, the stock of which is regularly traded on an established securities market. There is an assessable penalty for failure to reregister of $10,000 for each initial failure, plus $1,000 per day that the failure continues, and a criminal penalty for failure to reregister of $10,000, or imprisonment of not more than five years, or both, together with the costs of prosecution. The Senate amendment applies to changes in ownership occurring prior to, on, or after the date of enactment.

Effective date.–The Senate amendment is effective for actions or failures to act after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment and in addition makes the penalties for failure to reregister identical to the present-law penalties for failure to register by also providing for a non-assessable penalty for failure to reregister of $10,000.

[282] Sec. 6719.

[283] Sec. 7272(a).

[284] Sec. 7232.

[285] Treas. Reg. sec. 48.4101-1(h)(1)(v).

8. Reconciliation of on-loaded cargo to entered cargo (sec. 5616 of the Senate amendment and sec. 343 of the Trade Act of 2002)

Present Law

The Trade Act of 2002 directed the Secretary to promulgate regulations pertaining to the electronic transmission to the Bureau of Customs and Border Patrol ("Customs") of information pertaining to cargo destined for importation into the United States or exportation from the United States, prior to such importation or exportation.[286] The Department of the Treasury issued final regulations on October 31, 2002. The regulations require the advance and accurate presentation of certain manifest information prior to lading at the foreign port and encourage the presentation of this information electronically. Customs must receive from the carrier the vessel's Cargo Declaration (Customs Form 1302) or the electronic equivalent within 24 hours before such cargo is laden aboard the vessel at the foreign port.[287]

Certain carriers of bulk cargo, however, are exempt from these filing requirements. Such bulk cargo includes that composed of free flowing articles such as oil, grain, coal, ore and the like, which can be pumped or run through a chute or handled by dumping.[288] Thus, taxable fuels are not required to file the Cargo Declaration within 24 hours before such cargo is laden aboard the vessel at the foreign port. Instead the Cargo Declaration must be filed within 24 hours prior arrival in the United States.

House Bill

No provision.

Senate Amendment

The Senate amendment provides that not later than one year after the date of enactment of this paragraph, the Secretary of Homeland Security, together with the Secretary of the Treasury, is to establish an electronic data interchange system through which Customs shall transmit to the Internal Revenue Service information pertaining to cargoes of taxable fuels (as defined in section 4083) that Customs has obtained electronically under its regulations adopted to carry out the Trade Act of 2002 requirement. For this purpose, not later than one year after the date of enactment, all filers of required cargo information for such taxable fuels, as defined, must provide such information to Customs through its approved electronic data interchange system.

Effective date.−The Senate amendment is effective upon date of enactment.

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[286] Sec. 343(a) of Pub. L. No. 107-210 (2002).

[287] 19 CFR sec. 4.7(b)(2).

[288] 19 CFR sec. 4.7(b)(4)(i)(A).

Conference Agreement

The conference agreement follows the Senate amendment.

9. Registration of operators of deep-draft vessels (sec. 5617 of Senate amendment and secs. 4081 and 4101 of the Code)

Present Law

Blenders, enterers, pipeline operators, position holders, refiners, terminal operators, and vessel operators are required to register with the Secretary with respect to fuels taxes imposed by sections 4041(a)(1) and 4081.[289] Treasury regulations define a vessel operator as any person that operates a vessel within the bulk transfer/terminal system, excluding deep-draft ocean-going vessels.[290] Accordingly, operators of deep-draft ocean-going vessels are not required to register. A deep-draft ocean-going vessel is a vessel that is designed primarily for use on the high seas that has a draft of more than 12 feet.[291]

An assessable penalty for failure to register is $10,000 for each initial failure, plus $1,000 per day that the failure continues.[292] A non-assessable penalty for failure to register is $10,000.[293] A criminal penalty of $10,000, or imprisonment of not more than five years, or both, together with the costs of prosecution also applies to a failure to register and to certain false statements made in connection with a registration application.[294]

In general, gasoline, diesel fuel, and kerosene ("taxable fuel") are taxed upon removal from a refinery or a terminal.[295] Tax also is imposed on the entry into the United States of any taxable fuel for consumption, use, or warehousing. The tax does not apply to any removal or entry of a taxable fuel transferred in bulk (a "bulk transfer") by pipeline or vessel to a terminal or refinery if the person removing or entering the taxable fuel, the operator of such pipeline or vessel, and the operator of such terminal or refinery are registered with the Secretary as required by section 4101.[296] Transfer to an unregistered party subjects the transfer to tax.

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[289] Sec. 4101; Treas. Reg. sec. 48.4101-1(a) and 48.4101-1(c)(1).

[290] Treas. Reg. sec. 48.4101-1(b)(8).

[291] Sec. 4042(c)(1).

[292] Sec. 6719.

[293] Sec. 7272(a).

[294] Sec. 7232.

[295] Sec. 4081(a)(1)(A).

[296] Sec. 4081(a)(1)(B). The sale of a taxable fuel to an unregistered person prior to a taxable removal or entry of the fuel is subject to tax. Sec. 4081(a)(1)(A).

House Bill

No provision.

Senate Amendment

The Senate amendment provides that the Secretary of the Treasury shall require the registration of every operator of a deep-draft ocean going vessel. Under the provision, if a deep-draft ocean-going vessel is used as part of a bulk transfer of taxable fuel, the transfer is subject to tax unless the operator of such vessel is registered.

Effective date.–The Senate amendment is effective on the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment except that an operator of a deep-draft ocean-going vessel is not required to register under the provision if such operator uses such vessel exclusively for purposes of the entry of the taxable fuel. For purposes of the bulk transfer exemption, a deep-draft ocean-going vessel operator is not required to be registered for the exemption to be available with respect to the entry of taxable fuel by such vessel.

10. Gasoline blend stocks and kerosene (sec. 5618 of the Senate amendment and sec. 4083 of the Code)

Present Law

In general

A "taxable fuel" is gasoline, diesel fuel (including any liquid, other than gasoline, which is suitable for use as a fuel in a diesel-powered highway vehicle or train), and kerosene.[297] An excise tax is imposed upon (1) the removal of any taxable fuel from a refinery or terminal, (2) the entry of any taxable fuel into the United States, or (3) the sale of any taxable fuel to any person who is not registered with the IRS to receive untaxed fuel, unless there was a prior taxable removal or entry.[298] The tax does not apply to any removal or entry of taxable fuel transferred in bulk to a terminal or refinery if the person removing or entering the taxable fuel, the operator of such pipeline or vessel, and the operator of such terminal or refinery are registered with the Secretary.[299]

[297] Sec. 4083(a).

[298] Sec. 4081(a)(1).

[299] Sec. 4081(a)(1)(B).

Gasoline blend stocks

Definition

Under the regulations, "gasoline" includes all products commonly or commercially known or sold as gasoline and are suitable for use as a motor fuel, and that have an octane rating of 75 or more. Gasoline also includes, to the extent provided in regulations, gasoline blend stocks and products commonly used as additives in gasoline. By regulation, the Treasury has identified certain products as gasoline blend stocks,[300] however, the term "gasoline blend stocks" does not include any product that cannot be blended into gasoline without further processing or fractionation ("off-spec gasoline").

Gasoline blend stock exemptions

If certain conditions are met, the removal, entry, or sale of gasoline blend stocks is not taxable. Generally, the exemption from tax applies if a gasoline blend stock (1) is not used to produce finished gasoline (2) is received at an approved terminal or refinery (3) or in bulk transfer to an industrial user.[301]

Gasoline blend stocks not used to produce finished gasoline.–Pursuant to Treasury regulation, no tax is imposed on nonbulk removals from a terminal or refinery, or nonbulk entries into the United States of any gasoline blend stocks if (1) the person liable for the tax is a taxable fuel registrant, and (2) such person does not use the gasoline blend stocks to produce finished gasoline. In connection with a sale, no tax is imposed on the nonbulk removal or entry if (1) the person liable for the tax is a gasoline registrant and (2) at the time of sale such party has an unexpired certificate from the buyer, and has no reason to believe any information in the certificate is false.[302]

Any sale (or resale) of a gasoline blend stock that was not subject to tax on nonbulk removal or entry is taxable unless the seller has an unexpired certificate from the buyer and has no reason to believe that any information in the certificate is false.

The certificate to be provided by a buyer of gasoline blend stocks contains a statement that the gasoline blend stocks covered by the certificate will not be used to produce finished

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[300] Treas. Reg. sec. 48.4081-1(c)(3)(ii). The term "gasoline blend stocks" means alkylate; butane; catalytically cracked gasoline; coker gasoline; ethyl tertiary butyl ether (ETBE); hexane; hydrocrackate; isomerate; methyl tertiary butyl ether (MTBE); mixed xylene (not including any separated isomer of xylene); natural gasoline; pentane; pentane mixture; polymer gasoline; raffinate; reformate; straight-run gasoline; straight-run naphtha; tertiary amyl methyl ether (TAME); tertiary butyl alcohol (gasoline grade) (TBA); thermally cracked gasoline; and toluene. Treas. Reg. sec. 48.4081-1(c)(3)(i). Effective January 1, 2005, transmix containing gasoline was removed from the definition of gasoline blend stocks. Internal Revenue Service, Notice 2005-4 (December 15, 2004).

[301] Treas. Reg. sec. 48.4081-4.

[302] Treas. Reg. secs. 48.4081-4(b)(1) and 48.4081-4(b)(1)(2).

gasoline, identifies the type (or types of blend stocks) covered by the certificate and provides that the buyer will not claim a credit or refund for any gasoline covered by the certificate. The certificate is signed under penalties of perjury by a person with authority to bind the buyer. The certificate expires on the earliest of one year from the effective date of the certificate, the date a new certificate is provided to the seller or the date the seller is notified by the IRS or the buyer that the buyer's right to provide a certificate has been withdrawn.

Gasoline blend stocks received at an approved terminal or refinery.–Treasury regulations provide that tax is not imposed on the removal or entry of gasoline blend stocks that are received at a terminal or refinery if the person liable for tax is a taxable fuel registrant, has an unexpired notification certificate from the operator of the terminal or refinery where the gasoline blend stocks are received; and has no reason to believe that any information in the certificate is false.[303] A notification certificate is used to notify another person of the taxable fuel registrant's registration status.

Bulk transfer to an industrial user.–Tax is not imposed if upon removal of the gasoline blend stocks from a pipeline or vessel, the gasoline blend stocks are received by a taxable fuel registrant that is an industrial user.[304] An industrial user means any person that receives gasoline blend stocks by bulk transfer for its own use in the manufacture of any product other than finished gasoline.

Refunds or credits for tax imposed on gasoline blend stocks not used for producing gasoline

If any gasoline blend stock or additive is not used by a person to produce gasoline and that person establishes that the ultimate use of the gasoline blend stock or additive is not used to produce gasoline, then the Secretary is to pay (without interest) to such person, an amount equal to the aggregate amount of tax imposed on such person with respect to such gasoline or blend stock.[305]

If gasoline is used in an off-highway business use, the ultimate purchaser of the gasoline is entitled to a credit or refund for the excise taxes imposed on the fuel. "Off-highway business use" means any use by a person in a trade or business of such person otherwise than as a fuel in a highway vehicle that meets certain requirements.[306] Gasoline for this purpose includes gasoline blend stocks.[307]

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[303] Treas. Reg. sec. 48.4081-4(b)(1).

[304] Treas. Reg. sec. 48.4081-4(d).

[305] Sec. 6427(h)(1).

[306] Secs. 6421(a) and 6421(e).

[307] Sec. 6421(e)(1) and sec. 4083(a)(2)(B).

The Code also provides for a refund of tax for tax-paid fuel sold to a subsequent manufacturer or producer if the subsequent manufacturer or producer uses the fuel, for nonfuel purposes, as a material in the manufacture or production of any other article manufactured or produced by him.[308]

Kerosene

Definition of kerosene

By regulation, kerosene is defined as the kerosene described in ASTM Specification D 3699 (No. 1-K and No. 2-K), ASTM Specification D 1655 (kerosene-type jet fuel), and military specifications MIL-DTL-5624T (Grade JP-5) and MIL-DTL-83133E (Grade JP-8). Kerosene does not include any liquid that is an excluded liquid.[309]

An "excluded liquid" is (1) any liquid that contains less than four percent normal paraffins, or (2) any liquid that has a distillation range of 125 degrees Fahrenheit or less, sulfur content of 10 ppm or less, and minimum color of +27 Saybolt. These liquids are commonly known as "mineral spirits" and are obtained by distillation of crude oil. Mineral spirits are used for a wide variety of purposes, such as in dry-cleaning fluids, paint thinners, varnishes, photocopy toners, inks, adhesives, and as general purpose cleaners and degreasers.

Exemptions

Diesel fuel and kerosene that is to be used for a nontaxable purpose will not be taxed upon removal from the terminal if it is dyed to indicate its nontaxable purpose. Kerosene received by pipeline or vessel to satisfy a feedstock purpose is exempt from the dyeing requirement.[310] Pursuant to Treasury regulations, nonbulk removals of kerosene for a feedstock purpose by a registered feedstock user also are exempt.[311] The person receiving the kerosene must be registered with the IRS and provide a certificate noting that the kerosene will be used for a feedstock purpose in order for the exemption to apply. Pursuant to the Treasury regulations, tax also does not apply upon the removal or entry of kerosene if the person otherwise liable for tax is a taxable fuel registrant and such person uses the kerosene for a feedstock purpose.[312]

"Feedstock purpose" means the use of kerosene for nonfuel purposes in the manufacture or production of any substance (other than gasoline, diesel fuel or special fuels subject to tax).[313]

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[308] Sec. 6416(b)(3)(B).

[309] Treas. Reg. sec. 48.4081-1(b).

[310] Sec. 4082(d)(1).

[311] Treas. Reg. sec. 48.4082-7(c).

[312] Treas. Reg. sec. 48.4082-7(c).

[313] Treas. Reg. sec. 48.4082-7(b).

Thus, for example, kerosene is used for a feedstock purpose when it is used as an ingredient in the production of paint and is not used for a feedstock purpose when it is used to power machinery at a factory where paint is produced.

Refunds and payments for nontaxable uses of kerosene

If tax-paid kerosene is used by any person in a nontaxable use, the Secretary is required to pay (without interest) to the ultimate purchaser of such fuel an amount equal to the aggregate amount of tax imposed on such fuel. For this purpose, a nontaxable use is any use which is exempt from the tax imposed by section 4041(a)(1) other than by reason of prior imposition of tax. Claims relating to kerosene used on a farm for farming purposes and by a State are made by registered ultimate vendors. Claims relating to undyed kerosene sold from a blocked pump[314] or sold for blending with heating oil to be used during periods of extreme or unseasonable cold are also made by registered ultimate vendors. Special rules apply with respect to aviation-grade kerosene.

The Code also provides for a refund of tax for tax-paid fuel sold to a subsequent manufacturer or producer if the subsequent manufacturer or producer uses the fuel, for nonfuel purposes, as a material in the manufacture or production of any other article manufactured or produced by him.[315]

House Bill

No provision.

Senate Amendment

Gasoline blend stocks

The Senate amendment partially repeals exemptions provided in Treas. Reg. sec. 48.4081-4, which, under certain conditions, exempts from tax gasoline blend stocks that are not used to produce finished gasoline or that are received at an approved terminal or refinery. Under the Senate amendment, tax is imposed on all nonbulk entries and removals of gasoline blend stocks, regardless of whether they will be used to produce finished gasoline or received at an approved terminal or refinery. The Senate amendment does not change the exemption for bulk transfers to registered industrial users.

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[314] A blocked pump is a fuel pump that is used to dispense undyed kerosene that is sold at retail for use by the buyer in any nontaxable use; is at a fixed location; is identified with a legible and conspicuous notice stating "Undyed Untaxed Kerosene, Nontaxable Use Only"; and cannot reasonably be used to dispense fuel directly into the fuel supply tank of a diesel-powered highway vehicle or diesel-powered train; or is locked by the vendor after each sale and unlocked only in response to a request by a buyer for undyed kerosene for use other than as a fuel in a diesel-powered highway vehicle or diesel-powered train.

[315] Sec. 6416(b)(3)(B).

Kerosene and mineral spirits

The Senate amendment requires that with respect to fuel entered or removed after September 30, 2005, the Secretary shall include mineral spirits in the definition of kerosene. Thus, for entries and removals after September 30, 2005, mineral spirits are taxed and exempt from tax in the same manner as kerosene.

Effective date.−The Senate amendment is effective for fuel removed or entered after September 30, 2005.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

11. Nonapplication of export exemption to delivery of fuel to motor vehicles removed from United States (sec. 5619 of the Senate amendment)

Present Law

A "taxable fuel" is gasoline, diesel fuel (including any liquid, other than gasoline, which is suitable for use as a fuel in a diesel-powered highway vehicle or train), and kerosene.[316] An excise tax is imposed upon (1) the removal of any taxable fuel from a refinery or terminal, (2) the entry of any taxable fuel into the United States, or (3) the sale of any taxable fuel to any person who is not registered with the IRS to receive untaxed fuel, unless there was a prior taxable removal or entry.[317] The tax does not apply to any removal or entry of taxable fuel transferred in bulk to a terminal or refinery if the person removing or entering the taxable fuel, the operator of such pipeline or vessel, and the operator of such terminal or refinery are registered with the Secretary.[318]

Special provisions under the Code provide for a refund of tax to any person who sells gasoline to another for exportation.[319] Section 6421(c) provides "If gasoline is sold to any person for any purpose described in paragraph (2), (3), (4), or (5) of section 4221(a), the Secretary shall pay (without interest) to such person an amount equal to the product of the number of gallons so sold multiplied by the rate at which tax was imposed on such gasoline by section 4081." Section 4221 provides, in pertinent part, "Under regulations prescribed by the Secretary, no tax shall be imposed under this chapter. . . on the sale by the manufacturer. . . of an article–. . . for export, or for resale by the purchaser to a second purchaser for export. . . but only if such exportation or use is to occur before any other use . . .."

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[316] Sec. 4083(a).

[317] Sec. 4081(a)(1).

[318] Sec. 4081(a)(1)(B).

[319] Secs. 6421(c) and 4221(a)(2).

It is the IRS administrative position that the exemption from manufacturers excise tax by reason of exportation does not apply to the sale of motor fuel pumped into a fuel tank of a vehicle that is to be driven, or shipped, directly out of the United States.[320]

A duty-free sales facility that meets certain conditions may sell and deliver for export from the customs territory of the United States duty-free merchandise. Duty-free merchandise is merchandise sold by a duty-free sales facility on which neither Federal duty nor Federal tax has been assessed pending exportation from the customs territory of the United States. The statutes covering duty-free facilities do not contain any limitation on what goods may qualify for duty-free treatment.

The issue of whether fuel sold from a duty-free facility and placed into the tank of an automobile that is then driven out of the country is exported fuel has been litigated in the courts.[321] The cases involved the same operator of a duty-free facility seeking a refund of excise tax. The facility is near the Canadian border and is configured in such a way that anyone leaving the facility must depart the United States and enter into Canada. Both the Federal Circuit and the Sixth Circuit Court of Appeals are in accord with the IRS position and ruled that the operator of the duty-free facility did not have standing to pursue a claim for refund.[322]

House Bill

No provision.

Senate Amendment

The Senate amendment reaffirms the long-standing IRS position taken in Rev. Rul. 69-150 and restates present law by amending the Code definition of export to exclude the delivery of a taxable fuel into a fuel tank of a motor vehicle that is shipped or driven out of the United States. It also imposes a tax on the sale of taxable fuel at a duty-free sales enterprise unless there was a prior taxable removal, or entry of such fuel.

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[320] Rev. Rul. 69-150, 1969-1 C.B. 286.

[321] See *Ammex Inc. v. United States*, 52 Fed. Cl. 303 (2002) (on cross-motions for summary judgment, the court found that plaintiff established standing to proceed to trial pursuant to sec. 6421(c) respecting its gasoline purchases only); and *Ammex Inc. v. United States*, 2002 U.S. Dist. LEXIS 25771 (E.D. Mich. July 31, 2002) (granting defendant's motion for summary judgment), reconsideration denied, *Ammex, Inc. v. United States*, 2002 U.S. Dist. LEXIS 22893 (E.D. Mich. Oct. 22, 2002). Although the Claims Court ruled that Ammex had standing to challenge the excise tax on gasoline, it subsequently held that Ammex was not entitled to a payment pursuant to sec. 6421(c) because it failed to prove at trial that it did not pass the tax on to its customers. *Ammex Inc. v. United States*, 2003 U.S. Claims LEXIS 63 (Fed. Cl. Mar. 26, 2003). The Claims Court finding that the plaintiff had standing was reversed on appeal.

[322] See *Ammex Inc. v. United States*, 384 F.3d 1368 (Fed. Cir. 2004) *cert. denied* 125 S.Ct. 1697 (2005); and *Ammex Inc. v. United States*, 367 F.3d 530 (6th Cir. 2004) *cert. denied* 125 S.Ct. 1695 (2005).

Effective date.–The Senate amendment applies to sales or deliveries made after the date of enactment.

Conference Agreement

The conferees believe that it is beyond dispute that the delivery of fuel into a fuel tank of a motor vehicle that is shipped or driven out of the United States is not an act of exportation of such fuel. The fuel in the fuel tank is not carried in the vehicle for the purpose of transporting the fuel as a commodity from one place to another; the fuel is there to power the vehicle. The conference agreement does not include the Senate amendment because it is present law, supported by the decisions of two Federal appellate courts.

12. Impose assessable penalty on dealers of adulterated fuel (sec. 5620 of the Senate amendment and new sec. 6720A of the Code)

Present Law

Diesel fuel, gasoline, and kerosene are taxable fuels. Diesel fuel is defined as (1) any liquid (other than gasoline) which is suitable for use as a fuel in a diesel-powered highway vehicle or a diesel powered train, (2) transmix, and (3) diesel fuel blend stocks identified by the Secretary.[323] As a defense to Federal and State excise tax liability, some taxpayers have contended that certain diesel fuel mixtures or additives do not meet the requirements of (1) above because they are not approved as additives or mixtures by the EPA. In addition, under present law, untaxed fuel additives, including certain contaminants, may displace taxed diesel fuel in a mixture.

The Code provides that any person who, in connection with a sale or lease (or offer for sale or lease) of an article, knowingly makes any false statement ascribing a particular part of the price of the article to a tax imposed by the United States, or intended to lead any person to believe that any part of the price consists of such a tax, is guilty of a misdemeanor.[324] Another Code provision provides that any person who has in his custody or possession any article on which taxes are imposed by law, for the purpose of selling the article in fraud of the internal revenue laws or with design to avoid payment of the taxes thereon, is liable for "a penalty of $500 or not less than double the amount of taxes fraudulently attempted to be evaded."[325]

House Bill

No provision.

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[323] Sec. 4083(a)(3)(A).

[324] Sec. 7211. Such a violation is punishable by a fine not to exceed $1,000, or by imprisonment for not more than one year, or both.

[325] Sec. 7268.

Senate Amendment

The Senate amendment adds a new assessable penalty. Any person other than a retailer who knowingly transfers for resale, sells for resale, or holds out for resale for use in a diesel-powered highway vehicle (or train) any liquid that does not meet applicable EPA regulations (as defined in section 45H(c)(3)[326]) is subject to a penalty of $10,000 for each such transfer, sale or holding out for resale, in addition to the tax on such liquid, if any. Any retailer who knowingly holds out for sale (other than for resale) any such liquid, is subject to a $10,000 penalty for each such holding out for sale, in addition to the tax on such liquid, if any.

The penalty is dedicated to the Highway Trust Fund.

Effective date.–The Senate amendment is effective for any transfer, sale, or holding out for sale or resale occurring after the date of enactment.

Conference Agreement

The conference agreement follows the Senate amendment.

[326] Section 45H(c)(3) refers to "the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency."

IV. FUELS-RELATED TECHNICAL CORRECTIONS

A. Fuels-Related Technical Corrections to American Jobs Creation Act of 2004 ("AJCA")

The provision includes technical corrections to AJCA. Such technical corrections take effect as if included in the section of AJCA to which the correction relates.

1. Volumetric ethanol excise tax credit (sec. 10003(a) of the House bill, sec. 5401(a) of the Senate amendment, sec. 301 of AJCA, and sec. 6427 of the Code)

House Bill

AJCA repealed the reduced tax rates for alcohol fuels and taxable fuels to be blended with alcohol. The technical correction makes a conforming amendment to eliminate the refund provisions based on those reduced rates (secs. 6427(f) and 6427(o)).

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment.

2. Aviation fuel (sec. 10003(b) of the House bill, sec. 5401(b) of the Senate amendment, sec. 853 of AJCA, and sec. 4081 of the Code)

House Bill

Section 853 of AJCA moved the taxation of jet fuel (aviation-grade kerosene) from section 4091 to section 4081 of the Code and repealed section 4091. The termination date for the 21.8 cent per gallon rate for noncommercial aviation jet fuel was inadvertently omitted from the Act. The technical correction clarifies that after September 30, 2007, the rate for jet fuel used in noncommercial aviation will be 4.3 cents per gallon (sec. 4081(a)(2)(C)).

An additional technical correction clarifies that users of aviation fuel in commercial aviation are required to be registered with the IRS in order for the 4.3-cents-per-gallon rate to apply (including for purposes of the self-assessment of tax by commercial aircraft operators).

Senate Amendment

The Senate amendment generally follows the House bill with certain technical drafting changes to accommodate changes made by other provisions of the Senate amendment. The Senate amendment also corrects cross-references in section 6421(f)(2) to the definition of noncommercial aviation to reflect changes made by the AJCA change in the tax treatment of fuel used in aviation.

Conference Agreement

The conference agreement follows the Senate amendment.

B. Fuels-Related Technical Corrections to Transportation Equity Act for the 21st Century ("TEA 21")

The provision includes a technical correction to TEA 21. The amendment made by the technical correction takes effect as if included in the section of TEA 21 to which it relates.

1. Coastal Wetlands sub-account (sec. 5401(c) of the Senate amendment, sec. 9005 of TEA 21, and sec. 9504 of the Code)

House Bill

No provision.

Senate Amendment

Section 9005(b)(3) of TEA 21 redesignated Code section 9504(b)(2)(B), referring to the purposes of the Coastal Wetlands Planning, Protection and Restoration Act, as 9504(b)(2)(C), but did not cross reference the limitation for such purposes of taxes on gasoline used in the nonbusiness use of small-engine outdoor power equipment. The technical correction makes a conforming cross-reference amendment (sec. 9504(b)(2)).

Conference Agreement

The conference agreement follows the Senate amendment.

C. Correction to the Energy Tax Incentives Act of 2005

The provision includes a technical correction to the Energy Tax Incentives Act ("ETIA") of 2005. The amendment made by the technical correction takes effect as if included in the section of the ETIA to which it relates.

1. Erroneous reference to highway reauthorization bill (sec. 38 of the Code)

House Bill

No provision.

Senate Amendment

No provision.

Conference Agreement

The conference agreement corrects an erroneous reference to the highway reauthorization bill in section 38 as added by the Energy Policy Act of 2005.

V. TAX COMPLEXITY ANALYSIS

Section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998 (the "IRS Reform Act") requires the Joint Committee on Taxation (in consultation with the Internal Revenue Service and the Department of the Treasury) to provide a tax complexity analysis. The complexity analysis is required for all legislation reported by the Senate Committee on Finance, the House Committee on Ways and Means, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Internal Revenue Code (the "Code") and has widespread applicability to individuals or small businesses.

The staff of the Joint Committee on Taxation has determined that a complexity analysis is not required under section 4022(b) of the IRS Reform Act because the bill contains no provisions that have "widespread applicability" to individuals or small businesses.