# DESCRIPTION OF S. _____
# "ENERGY TAX INCENTIVES ACT OF 2002"

Scheduled for Markup
by the
Senate Finance Committee
on February 13, 2002

Prepared by
the Staff of the
JOINT COMMTTEE ON TAXATION

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CONTENTS

## INTRODUCTION

The Senate Committee on Finance has scheduled a markup on February 13, 2002, of S. _____ "Energy Tax Incentives Act of 2002." This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the "Energy Tax Incentives Act of 2002."

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of S. _____ ,"Energy Tax Incentives Act of 2002*" (JCX-2-02), February 11, 2002.

## I. RENEWABLE ENERGY

### A. Extension and Modification of the Section 45 Electricity Production Credit

#### Present Law

An income tax credit is allowed for the production of electricity from either qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste facilities (sec. 45). The amount of the credit is 1.5 cents per kilowatt hour (indexed for inflation) of electricity produced. The amount of the credit was 1.7 cents per kilowatt hour for 2001. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits.

The credit applies to electricity produced by a wind energy facility placed in service after December 31, 1993, and before January 1, 2002, to electricity produced by a closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2002, and to a poultry waste facility placed in service after December 31, 1999, and before January 1, 2002. The credit is allowable for production during the 10-year period after a facility is originally placed in service. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party. In the case of a poultry waste facility, the taxpayer may claim the credit as a lessee/operator of a facility owned by a governmental unit.

Closed-loop biomass is plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not include waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). The credit also is not available to taxpayers who use standing timber to produce electricity. Poultry waste means poultry manure and litter, including wood shavings, straw, rice hulls, and other bedding material for the disposition of manure.

The credit for electricity produced from wind, closed-loop biomass, or poultry waste is a component of the general business credit (sec. 38(b)(8)). The credit, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000, or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39). To coordinate the carryback with the period of application for this credit, the credit for electricity produced from closed-loop biomass facilities may not be carried back to a tax year ending before 1993 and the credit for electricity produced from wind energy may not be carried back to a tax year ending before 1994 (sec. 39).

#### Description of Proposal

The proposal would extend the placed in service date for wind facilities, closed-loop biomass facilities, and poultry waste facilities to facilities placed in service after December 31, 1993 (December 31, 1992 in the case of closed-loop biomass facilities and December 31, 1999 in the case of poultry waste facilities) and before January 1, 2007.

The proposal also would define three new qualifying energy resources: open-loop biomass, swine and bovine waste nutrients, and geothermal energy. Open-loop biomass would

be defined as any solid, nonhazardous, cellulosic waste material which is segregated from other waste materials and which is derived from any of forest-related resources, solid wood waste materials, or agricultural sources. Eligible forest-related resources would be defined as mill residues, precommercial thinnings, slash, and brush, but not including old-growth timber. Solid wood waste materials would include waste pallets, crates, dunnage, manufacturing and construction wood wastes (other than pressure-treated, chemically-treated, or painted wood wastes), and landscape or right-of-way tree trimmings. Agricultural sources would include orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues. However, qualifying open-loop biomass would not include municipal solid waste (garbage), gas derived from biodegradation of solid waste, or paper that is commonly recycled. Swine and bovine waste nutrients would be defined as swine and bovine manure and litter, including bedding material for the disposition of manure. Geothermal energy would be defined as energy derived from a geothermal deposit which is a geothermal reservoir consisting of natural heat which is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure).

Qualifying open-loop biomass facilities would be facilities using open-loop biomass to produce electricity that are placed in service prior to January 1, 2005. Qualifying swine and bovine waste nutrient facilities would be facilities using swine and bovine waste nutrients to produce electricity that are placed in service after the date of enactment and before January 1, 2007. Qualifying geothermal energy facilities would be facilities using geothermal deposits to produce electricity that are placed in service after the date of enactment and before January 1, 2007.

In the case of qualifying open-loop biomass facilities, taxpayers would be able to claim the otherwise allowable credit for a three-year period. For facilities placed in service after the date of enactment, the three-year period would commence when the facility is placed in service. In the case of open-loop biomass facilities originally placed in service before the date of enactment, the three-year period would commence after December 31, 2002 and the otherwise allowable 1.5 cent-per-kilowatt-hour credit (adjusted for inflation) would be reduced to 1.0 cent-per-kilowatt-hour credit (adjusted for inflation). In the case of qualifying geothermal energy facilities, taxpayers would be able to claim the otherwise allowable credit for the five-year period commencing when the facility is placed service.

The proposal would modify present law to provide that qualifying closed-loop biomass facilities include any facility originally placed in service before December 31, 1992 and modified to use closed-loop biomass to co-fire with coal before January 1, 2007.

In the case of qualifying open-loop biomass facilities and qualifying closed-loop biomass facilities modified to use closed-loop biomass to co-fire with coal, the proposal would permit a lessee operator to claim the credit in lieu of the owner of the facilities.

The proposal would provide that certain persons (public utilities, electric cooperatives, rural electric cooperatives, and Indian tribes) could sell, trade, or assign to any taxpayer any credits that would otherwise be allowable to that person, if that person were a taxpayer, for production of electricity from a qualified facility owned by such person. In addition, any credits that would otherwise be allowable to such person may be applied as a prepayment to certain loans or obligations undertaken by such person under the Rural Electrification Act of 1936.

Lastly, the proposal would repeal the present-law reduction in allowable credit for facilities financed with tax-exempt bonds or with certain loans received under the Rural Electrification Act of 1936.

## Effective Date

The proposal generally would be effective for electricity sold from qualifying facilities after the date of enactment. For electricity produced from qualifying open-loop biomass facilities originally placed in service prior to the date of enactment, the proposal would be effective January 1, 2003.

## II. ALTERNATIVE VEHICLES AND FUEL INCENTIVES

### A. Modifications and Extensions of Provisions Relating to Electric Vehicles, Clean-Fuel Vehicles, and Clean-Fuel Vehicle Refueling Property

#### Present Law

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000 (sec. 30). A qualified electric vehicle is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current, the original use of which commences with the taxpayer, and that is acquired for the use by the taxpayer and not for resale. The full amount of the credit is available for purchases prior to 2002. The credit phases down in the years 2002 through 2004, and is unavailable for purchases after December 31, 2004. There is no carry forward or carryback of the credit for electric vehicles.

Certain costs of qualified clean-fuel vehicle property and clean-fuel vehicle refueling property may be expensed and deducted when such property is placed in service (sec. 179A). Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (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). The maximum amount of the deduction is $50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with seating capacities of at least 20 adults; $5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and $2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction.

Clean-fuel vehicle refueling property comprises property for the storage or dispensing of a clean-burning fuel, if the storage or dispensing is the point at which the fuel is delivered into the fuel tank of a motor vehicle. Clean-fuel vehicle refueling property also includes property for the recharging of electric vehicles, but only if the property is located at a point where the electric vehicle is recharged. Up to $100,000 of such property at each location owned by the taxpayer may be expensed with respect to that location.

The deduction phases down in the years 2002 through 2004, and is unavailable for purchases after December 31, 2004.

#### Description of Proposal

**Alternative motor vehicle credits**

The proposal would provide a credit to the taxpayer for the purchase of a new qualified fuel cell motor vehicle, a new qualified alternative fuel motor vehicle, and a new qualified hybrid motor vehicle. The taxpayer would be able to carry forward unused credits for 20 years or carry unused credits back for three years (but not carried back to taxable years beginning before the January 1, 2003). In the case of property purchased by tax-exempt persons, the seller may claim

the credit. In addition to the specifications described below, a qualifying vehicle would have to meet certain emissions standards.

Fuel cell motor vehicles

The credit for the purchase of new qualified fuel cell motor vehicles generally ranges between $4,000 and $40,000 depending upon the weight class of the vehicle. For automobiles and light trucks, the otherwise allowable credit amount ($4,000) is increased by an amount from $1,000 to $4,000 depending upon the vehicle's fuel efficiency compared to a stated standard. Credit may not be claimed for qualified fuel cell motor vehicles purchased after December 31, 2011. The taxpayer's basis in the property is reduced by the amount of credit claimed.

Hybrid motor vehicles

The credit for the purchase of a new qualified hybrid motor vehicle generally ranges from $250 to $10,000 depending upon the weight of the vehicle and the maximum power available from the vehicle's battery system. For automobiles and light trucks, the otherwise allowable credit amount ($250 to $1,000) is increased by an amount from $1,000 to $3,500 depending upon the vehicle's fuel efficiency. For heavy duty hybrid motor vehicles, the otherwise allowable credit ($1,000 to $10,000) is increased depending upon the vehicle's weight and provided the vehicle meets certain 2007 (and beyond) emissions standards. The amount of credit is increased by between $3,000 and $12,000 for vehicles placed in service in 2003, is increased by between $2,500 and $10,000 for vehicles placed in service in 2004, is increased by between $2,000 and $8,000 for vehicles placed in service in 2005, and is increased by between $1,500 and $6,000 for vehicles placed in service in 2006. Credit may not be claimed for qualified hybrid motor vehicles purchased after December 31, 2006. The taxpayer's basis in the property is reduced by the amount of credit claimed.

Alternative fuel motor vehicles

The credit for the purchase of a new alternative fuel motor vehicle equals 40 percent of the incremental cost of such vehicle, plus an additional 30 percent if the vehicle meets certain emissions standards. For computation of the credit, incremental costs of the vehicle may not exceed between $5,000 and $40,000 depending upon the weight of the vehicle. For this purpose, incremental cost generally would be defined as the amount of the increase of the cost of such a vehicle compared to the cost of a comparable gasoline or diesel model. Qualifying alternative fuels are compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid mixture consisting of at least 85 percent methanol.

Certain mixed-fuel vehicles also could claim the alternative fuel motor vehicle credit, at a reduced rate. A mixed-fuel vehicle is a vehicle with gross weight of seven tons or more and is certified by the manufacturer as being able to operate on a combination of alternative fuel and a petroleum-based fuel. A qualifying mixed-fuel vehicle must use at least 75 percent alternative fuel (a "75/25 mixed-fuel vehicle") or 90 percent alternative fuel (a "90/10 mixed-fuel vehicle") and is incapable of operating on a mixture containing less than 75 percent alternative fuel in the case of a 75/25 vehicle (less than 90 percent alternative fuel in the case of a 90/10 vehicle. A taxpayer purchasing a 75/25 mixed-fuel vehicle may claim 70 percent of the otherwise allowable

credit. A taxpayer purchasing a 90/10 mixed-fuel vehicle may claim 90 percent of the otherwise allowable credit.

Credit may not be claimed for qualified alternative fuel motor vehicles purchased after December 31, 2006. The taxpayer's basis in the property is reduced by the amount of credit claimed.

**Modification of credit for qualified electric vehicles**

The proposal would modify the present-law credit for electric vehicles to provide that the credit for qualifying vehicles generally ranges between $3,500 and $40,000 depending upon the weight of the vehicle and, for certain vehicles, the driving range of the vehicle. In the case of property purchased by tax-exempt persons, the seller may claim the credit. The taxpayer would be ineligible for the deduction allowable under present-law section 179A for a qualified battery electric vehicle on which a credit is allowable. The proposal also would extend the expiration date of the credit from December 31, 2004 to December 31, 2006 and would repeal the phaseout schedule of present law. The taxpayer would be able to carry forward unused credits for 20 years or carry unused credits back for three years (but not carried back to taxable years beginning before the January 1, 2003).

**Extension of present-law section 179A**

The proposal would extend the deduction for costs of qualified clean-fuel vehicle property and clean-fuel vehicle refueling property through December 31, 2006. The phase-down of present law for clean fuel vehicles would be modified such that the taxpayer may claim 75 percent of the otherwise allowable deduction in 2003 and 2004, 50 percent of the otherwise allowable deduction in 2005, and 75 percent of the otherwise allowable deduction in 2006.

**Credit for installation of alternative fueling stations**

The proposal would permit 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 the allowable credit could not exceed $30,000. In the case of residential clean-fuel vehicle refueling property the allowable credit could not exceed $1,000. The taxpayer's basis in the property would be reduced by the amount of the credit and the taxpayer could 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, 2007. Taxpayers would be able to carry forward unused credits for 20 years.

**Credit for retail sale of alternative fuels**

The proposal would permit taxpayers to claim a credit equal to the gasoline gallon equivalent of 30 cents per gallon of alternative fuel sold in 2003, 40 cents per gallon in 2004, and 50 cents per gallon thereafter. Qualifying alternative fuels are compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, any liquid mixture consisting of at least 85

percent methanol, and any liquid mixture consisting of at least 85 percent ethanol. The gasoline gallon equivalency of any alternative fuel is determined by reference to the British thermal unit content of the alternative fuel compared to a gallon of gasoline. The credit may be claimed for sales prior to January 1, 2007. The credit would be part of the general business credit.

## Effective Date

The proposals relating to the credit for new fuel cell motor vehicles, hybrid motor vehicles, and alternative fuel motor vehicles, the credit for battery electric vehicles, the credit for alternative fuel vehicle refueling property, and deductions clean fuel vehicles and clean fuel refueling property would apply to property placed in service after December 31, 2002, in taxable years ending after December 31, 2002. The credit for retail sales of alternative fuels would apply to sales of fuels after December 31, 2002, in taxable years ending after December 31, 2002.

## B. Modifications to Small Producer Ethanol Credit

### Present Law

#### Small producer credit

Present law provides several tax benefits for ethanol and methanol produced from renewable sources (e.g., biomass) that are used as a motor fuel or that are blended with other fuels (e.g., gasoline) for such a use. In the case of ethanol, a separate 10-cents-per-gallon credit for small producers, defined generally as persons whose production does not exceed 15 million gallons per year and whose production capacity does not exceed 30 million gallons per year. The alcohol fuels tax credits are includible in income. This credit, like tax credits generally, may not be used to offset alternative minimum tax liability. The credit is a treated as a general business credit, subject to the ordering rules and carryforward/carryback rules that apply to business credits generally. The alcohol fuels tax credit is scheduled to expire after December 31, 2007.

#### Taxation of cooperatives and their patrons

Under present law, cooperatives in essence are treated as pass-through entities in that the cooperative is not subject to corporate income tax to the extent the cooperative timely pays patronage dividends. Under present law (sec. 38(d)(4)), the only excess credits that may be flowed-through to cooperative patrons are the rehabilitation credit (sec. 47), the energy property credit (sec. 48(a)), and the reforestation credit (sec. 48(b)).

### Description of Proposal

The proposal would make several modifications to the rules governing the small producer ethanol credit. First, the proposal would liberalize the definition of an eligible small producer to include persons whose production capacity does not exceed 60 million gallons. Second, the proposal would allow cooperatives to elect to pass-through the small ethanol producer credits to its patrons. The credit allowed to a particular patron would be that proportion of the credit that the cooperative elects to pass-through for that year as the amount of patronage of that patron for that year bears to total patronage of all patrons for that year.

Third, the proposal would repeal the rule that includes the small producer credit in income of taxpayers claiming it and would liberalize the ordering and carryforward/carryback rules for the small producer ethanol credit. Fourth, the proposal would allow the small producer credit to be claimed against the alternative minimum tax. Finally, the proposal would provide that the small producer ethanol credit would not be treated as derived from a passive activity under the Code rules restricting credits and deductions attributable to such activities.

### Effective Date

The proposal would be effective for taxable years beginning after date of enactment.

## C. Transfer Full Amount of Excise Tax Imposed on Gasohol to the Highway Trust Fund

### Present Law

An 18.4 cents-per-gallon excise tax is imposed on gasoline. The tax is imposed when the fuel is removed from a refinery unless the removal is to a bulk transportation facility (e.g., removal by pipeline or barge to a registered terminal). In the case gasoline removed in bulk by registered parties, tax is imposed when the gasoline is removed from the terminal facility, typically by truck (i.e., "breaks bulk"). If gasoline is sold to an unregistered party before it is removed from a terminal, tax is imposed on that sale. When the gasoline subsequently breaks bulk, a second tax is imposed. The payor of the second tax may file a refund claim if it can prove payment of the first tax. The party liable for payment of the gasoline excise tax is called a "position holder," defined as the owner of record inside the refinery or terminal facility.

A 53-cents-per-gallon income tax credit is allowed for ethanol used as a motor fuel (the "alcohol fuels credit"). The benefit of the alcohol fuels tax credit may be claimed as a reduction in excise tax payments when the ethanol is blended with gasoline ("gasohol"). The reduction is based on the amount of ethanol contained in the gasohol. The excise tax benefits apply to gasohol blends of 90 percent gasoline/10 percent ethanol, 92.3 percent gasoline/7.7 percent ethanol, or 94.3 percent gasoline/5.7 percent ethanol. The income tax credit is based on the amount of alcohol contained in the blended fuel.

In general, 18.3 cents per gallon of the gasoline excise tax is deposited in the Highway Trust Fund and 0.1 cent per gallon is deposited in the Leaking Underground Storage Tank Trust Fund (the "LUST" rate). In the case of gasohol with respect to which a reduced excise tax is paid, 2.5 cents per gallon of the reduced tax is retained in the General Fund. The balance of the reduced rate (less the LUST rate) is deposited in the Highway Trust Fund.

### Description of Proposal

The proposal would transfer the 2.5 cents per gallon of excise tax on gasohol that currently is retained in the General Fund to the Highway Trust Fund.

### Effective Date

The proposal would be effective taxes imposed after September 31, 2003.

## D. Modify Income Tax and Excise Tax Rules Governing Treatment of ETBE

### Present Law

An 18.4 cents-per-gallon excise tax is imposed on gasoline. The tax is imposed when the fuel is removed from a refinery unless the removal is to a bulk transportation facility (e.g., removal by pipeline or barge to a registered terminal). In the case gasoline removed in bulk by registered parties, tax is imposed when the gasoline is removed from the terminal facility, typically by truck (i.e., "breaks bulk"). If gasoline is sold to an unregistered party before it is removed from a terminal, tax is imposed on that sale. When the gasoline subsequently breaks bulk, a second tax is imposed. The payor of the second tax may file a refund claim if it can prove payment of the first tax. The party liable for payment of the gasoline excise tax is called a "position holder," defined as the owner of record inside the refinery or terminal facility.

A 53-cents-per-gallon income tax credit is allowed for ethanol used as a motor fuel (the "alcohol fuels credit"). The benefit of the alcohol fuels tax credit may be claimed as a reduction in excise tax payments when the ethanol is blended with gasoline ("gasohol"). The reduction is based on the amount of ethanol contained in the gasohol. The excise tax benefits apply to gasohol blends of 90 percent gasoline/10 percent ethanol, 92.3 percent gasoline/7.7 percent ethanol, or 94.3 percent gasoline/5.7 percent ethanol. The income tax credit is based on the amount of alcohol contained in the blended fuel.

ETBE is an ether that is manufactured using ethanol. Unlike ethanol, ETBE can be blended with gasoline before the gasoline enters a pipeline because ETBE does not result in contamination of fuel with water while in transport. Treasury Department regulations provide that gasohol blenders may claim the income tax credit and excise tax rate reductions for ethanol used in the production of ETBE. The regulations also a special election allowing refiners to claim the benefit of the excise tax rate reduction even though the fuel being removed from terminals does not contain the requisite percentages of ethanol for claiming the excise tax rate reduction.

### Description of Proposal

The proposal would replace the present-law regulatory procedures enabling refiners to claim excise tax benefits on ETBE-blended gasohol with a new excise tax credit alternative to the alcohol fuels income tax credit. Under the proposal, in lieu of excise tax rate reductions for specified gasohol blends, a refiner blending ETBE and ethanol would accrue an excise tax credit equal to the amount of the alcohol fuels credit or excise tax rate reduction otherwise available for the ETBE blended fuel. The refiner could use this credit to offset its excise tax liability for highway motor fuels under Code section 4081. Alternatively, the credit could be transferred to a registered position holder that is a member of the same controlled group as the refiner, and the position holder could use the excise tax credit to offset its liability for excise taxes under those Code sections.

## Effective Date

The proposal would be effective for fuels blended after date of enactment.

## III. CONSERVATION AND ENERGY EFFICIENCY PROVISIONS

### A. Business Credit for Construction of New Energy-Efficient Homes

#### Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for the construction of new energy-efficient homes.

#### Description of Proposal

The proposal would provide a credit to an eligible contractor of an amount equal to the aggregate adjusted bases of all energy-efficient property installed in a qualified new energy-efficient home during construction. The credit cannot exceed $1,250 ($2,000) in the case of a new home which has a projected level of annual heating and cooling costs that is 30 percent (50 percent) less than a comparable dwelling constructed in accordance with Chapter 4 of the 2000 International Energy Conservation Code.

The eligible contractor would be the person who constructed the home, or in the case of a manufactured home, the producer of such home. Energy efficiency property would be any energy-efficient building envelope component (insulation materials or system designed to reduce heat loss or gain, and exterior windows, including skylights, and doors) and any energy-efficient heating or cooling appliance that can, individually or in combination with other components, meet the standards for the home.

To qualify as an energy-efficient new home, the home must be: (1) a dwelling located in the United States; (2) the principal residence of the person who acquires the dwelling from the eligible contractor; and (3) certified to have a projected level of annual heating and cooling

energy consumption that meets the standards for either the 30-percent or 50-percent credit. The home may be certified according to a component-based method or an energy performance based method.

## Effective Date

The credit applies to homes whose construction is substantially completed after the date of enactment and which are purchased during the period beginning on the date of enactment and ending on December 31, 2007.

## B. Tax Credit for Energy-Efficient Appliances

### Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment: (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat; or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of: (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for the manufacture of energy-efficient appliances.

### Description of Proposal

The proposal would provide a credit for the production of certain energy-efficient clothes washers and refrigerators. The credit would equal $50 per appliance for energy-efficient clothes washers produced with a modified energy factor ("MEF") of 1.26 or greater and for refrigerators produced that consume 10 percent less kilowatt-hours per year than the energy conservation standards promulgated by the Department of Energy that took effect on July 1, 2001. The credit would equal $100 for energy-efficient clothes washers produced with a MEF of 1.42 or greater (1.5 or greater for washers produced after 2004) and for refrigerators produced that consume 15 percent less kilowatt-hours per year than the energy conservation standards promulgated by the Department of Energy that took effect on July 1, 2001. An energy-efficient refrigerator would be an automatic defrost refrigerator-freezer with an internal volume of at least 16.5 cubic feet to qualify for the credit. An energy-efficient clothes washer would be any residential clothes washer, including a residential style coin operated washer.

For each category of appliances (i.e., washers that meet the lower MEF standard, washers that meet the higher MEF standard, refrigerators that meet the 10 percent standard, refrigerators that meet the 15 percent standard), only production in excess of average production for each such category during calendar years 1999-2001 would be eligible for the credit. The taxpayer may not claim credits in excess of $30 million for all taxable years for appliances that qualify for the $50 credit, and may not claim credits in excess of $30 million for all taxable years for appliances that

qualify for the $100 credit. Additionally, the credit allowed for all appliances may not exceed two percent of the average annual gross receipts of the taxpayer for the three taxable years preceding the taxable year in which the credit is determined. The present-law carry back rules of the general business credit generally would apply except that no credits attributable to energy-efficient appliances may be carried back before the effective date of this provision.

**Effective Date**

The credit would apply to appliances produced after December 31, 2002 and prior to (1) January 1, 2005 in the case of refrigerators that only meet the 10 percent credit standard, or (2) January 1, 2007 in the case of all other qualified energy-efficient appliances.

## C. Tax Credit for Residential Fuel Cell, Solar and Wind Energy

### Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law personal tax credit for residential fuel cell, solar or wind energy property.

### Description of Proposal

The proposal would provide a personal tax credit for the purchase of qualified wind energy property, qualified photovoltaic property, and qualified solar water heating property that is used exclusively for purposes other than heating swimming pools and hot tubs. The credit would be equal to 15 percent for solar water heating property and photovoltaic property, and would be equal to 30 percent for wind energy property. The maximum credit for each of these systems of property would be $2,000. The proposal would also provide a 30 percent credit for the purchase of qualified stationary or portable fuel cell power plants. The credit for any fuel cell may not exceed $1,000 for each kilowatt of capacity.

The credit would be nonrefundable and would be allowed against the regular and minimum tax. The depreciable basis of the property would be reduced by the amount of the credit.

Qualifying solar water heating property would mean an expenditure for property to heat water for use in a dwelling unit located in the United States and used as a residence if at least half of the energy used by such property for such purpose is derived from the sun. Qualified photovoltaic property would be property that uses solar energy to generate electricity for use in a dwelling unit. Solar panels would be treated as qualified photovoltaic property. Qualified wind energy property would be property that uses wind energy to generate electricity for use in a

dwelling unit. A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that converts a fuel into electricity using electrochemical means, and which has an electricity-only generation efficiency of greater than 30 percent and generates at least 1 kilowatt of electricity using an electrochemical process. The qualified fuel cell power plant must be installed on or in connection with a dwelling unit located in the United States and used by the taxpayer as a principal residence. Expenditures for labor costs allocable to onsite preparation, assembly, or original installation of property eligible for the credit would be eligible expenditures.

Certain equipment safety requirements would need to be met to qualify for the credit. Special proration rules would apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations.

**Effective Date**

The credit would apply to purchases after December 31, 2002 and before January 1, 2008.

## D. Business Tax Incentives for Fuel Cells

### Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for fuel cell power plant property.

### Description of Proposal

The proposal would provide a 30 percent credit for the purchase of qualified fuel cell power plants for businesses. A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that converts a fuel into electricity using electrochemical means, and which has an electricity-only generation efficiency of greater than 30 percent and which generates at least 1 kilowatt of electricity. The credit for any fuel cell may not exceed $1,000 for each kilowatt of capacity. The credit would be nonrefundable. The taxpayer’s basis in the property would be reduced by the amount of the credit claimed.

### Effective Date

The credit for businesses would apply to property placed in service after December 31, 2002 and before January 1, 2007, under rules similar to rules of section 48(m) of the Internal Revenue Code of 1986 (as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990).

## E. Allowance of Deduction for Energy-Efficient Commercial Building Property

### Present Law

No special deduction is currently provided for expenses incurred for energy-efficient commercial building property.

### Description of Proposal

The proposal would provide a deduction equal to energy-efficient commercial building property expenditures made by the taxpayer. Energy-efficient commercial building property expenditures would be amounts paid or incurred for energy-efficient commercial building property installed in connection with the new construction or reconstruction of property: (1) which would otherwise be depreciable property; (2) which is located in the United States, and (3) the construction or erection of which is completed by the taxpayer. The deduction would be limited to an amount equal to the product of $2.25 and the square footage of the property for which such expenditures were made. The deduction would be allowed in the year in which the property is placed in service.

Energy-efficient commercial building property would mean any property that reduces total annual energy and power costs with respect to the lighting, heating, cooling, ventilation, and hot water supply systems of the building by 50 percent or more in comparison to a reference building which meets the requirements of a Standard 90.1-1999 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America. Certain certification requirements would have to be met.

For public property, such as schools, the Secretary would issue regulations to allow the deduction to be allocated to the person primarily responsible for designing the property in lieu of the public entity owner. Other rules would apply.

### Effective Date

The proposal is effective for taxable years beginning after October 1, 2002 for plans certified prior to December 31, 2007, whose construction is completed on or before December 31, 2009.

## F. Allowance of Deduction for Qualified Energy Management Devices and Retrofitted Qualified Meters

### Present Law

No special deduction is currently provided for expenses incurred for qualified energy management devices.

### Description of Proposal

The proposal would provide a $30 deduction for each qualified new or retrofitted energy management device placed in service by any taxpayer who is a supplier of electric energy or natural gas or is a provider of electric energy or natural gas services. A qualified energy management device would be any tangible property eligible for accelerated depreciation under section 168 and which is acquired and used by the taxpayer to enable consumers or others to manage their purchase, sale, or use of electricity in response to energy price and usage signals and which permits reading of energy price and usage signals on at least a daily basis.

The deduction would not be allowed to property used outside of the United States. The taxpayer would have basis reduction for such property equal to the deduction. Other rules would apply.

### Effective Date

The proposal would be effective for any qualified energy management device placed in service after the date of enactment of the Act.

## G. Three-Year Applicable Recovery Period for Depreciation of Qualified Energy Management Devices

### Present Law

No special recovery period is currently provided for depreciation of qualified energy management devices.

### Description of Proposal

The proposal would provide a 3-year recovery period for qualified new or retrofitted energy management devices placed in service by any taxpayer who is a supplier of electric energy or natural gas or is a provider of electric energy or natural gas services. A qualified energy management device would be any tangible property eligible for accelerated depreciation under code section 168 and which is acquired and used by the taxpayer to enable consumers or others to manage their purchase, sale, or use of electricity in response to energy price and usage signals and which permits reading of energy price and usage signals on at least a daily basis.

### Effective Date

The proposal would be effective for any qualified energy management device placed in service after the date of enactment of the Act.

## H. Energy Credit for Combined Heat and Power System Property

### Present Law

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for combined heat and power ("CHP") property.

### Description of Proposal

The proposal would provide a 10 percent credit for the purchase of combined heat and power property.

CHP property would mean property: (1) which uses the same energy source for the simultaneous or sequential generation of electrical power, mechanical shaft power, or both, in combination with the generation of steam or other forms of useful thermal energy (including heating and cooling applications); (2) which has an electrical capacity of more than 50 kilowatts or a mechanical energy capacity of more than 67 horsepower or an equivalent combination of electrical and mechanical energy capacities; (3) which produces at least 20 percent of its total useful energy in the form of thermal energy and at least 20 percent in the form of electrical or mechanical power (or a combination thereof); and (4) the energy efficiency percentage of which exceeds 60 percent (70 percent in the case of a system with an electrical capacity in excess of 50 megawatts or a mechanical energy capacity in excess of 67,000 horsepower, or an equivalent combination of electrical and mechanical capacities.)

CHP property would not include property used to transport the energy source to the generating facility or to distribute energy produced by the facility.

If a taxpayer is allowed a credit for CHP property, and the property would ordinarily have a depreciation class life of 15 years or less, the depreciation period for the property is treated as having a 22-year class life. The present-law carry back rules of the general business credit generally would apply except that no credits attributable to combined heat and power property may be carried back before the effective date of this provision.

**Effective Date**

The credit would apply to property placed in service after December 31, 2002 and before January 1, 2007.

# IV. CLEAN COAL INCENTIVES

## A. Investment and Production Credits for Clean Coal Technology

### Present Law

Present law does not provide an investment credit for electricity generating facilities that use coal as a fuel. Nor does present law provide a production credit for electricity generated at facilities that use coal as a fuel. However, a nonrefundable, 10-percent investment tax credit ("business energy credit") is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) that is used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage (sec. 48). Also, an income tax credit is allowed for the production of electricity from either qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste facilities placed in service prior to January 1, 2002 (sec. 45). The credit allowed equals 1.5 cents per kilowatt-hour of electricity sold. The 1.5 cent figure is indexed for inflation and equals 1.7 cents for 2001. The credit is allowable for production during the 10-year period after a facility is originally placed in service. The business energy tax credits and the production tax credit are components of the general business credit (sec. 38(b)(1)).

### Description of Proposal

#### In general

The proposal would create three new credits: a production credit for electricity produced from qualifying clean coal technology units; a production credit for electricity produced from qualifying advanced clean coal technology; and a credit for investments in qualifying advanced clean coal technology facilities. Certain persons (public utilities, electric cooperatives, and the Tennessee Valley Authority) would be eligible to obtain certifications from the Secretary of the Treasury (as described below) for each of these credits and sell, trade, or assign the credit to any taxpayer.

#### Credit for investments in qualifying advanced clean coal technology facilities

The proposal would provide a 10-percent investment tax credit for qualified investments in advanced clean coal technology facilities. Qualifying advanced clean coal electricity production facilities must utilize advanced pulverized coal or atmospheric fluidized bed combustion technology, pressurized fluidized bed combustion technology, integrated gasification combined cycle technology, or some other technology certified by the Secretary of Energy. Any qualifying facility must meet certain capacity standards, thermal efficiency standards, and emissions standards for $SO_2$, nitrous oxides, particulate emissions, and source emissions standards as provided in the Clean Air Act. A qualifying advanced clean coal facility would not include any facility that uses "refined coal" (as defined Part V.J., of this document). In addition, the taxpayer would not be able to claim any investment credit with respect to a facility for which the taxpayer is not eligible to claim a production credit for electricity produced from any qualified advanced clean coal technology electricity generation unit as described below.

To be a qualified investment in advanced clean coal technology, the taxpayer must receive a certificate from the Secretary of the Treasury. The Secretary may grant certificates to investments only to the point that 4,000 megawatts of electricity production capacity qualifies for the credit. From the potential pool of 4,000 megawatts of capacity, not more than 1,000 megawatts in total and not more than 500 megawatts in years prior to 2009 shall be allocated to facilities using advanced pulverized coal or atmospheric fluidized bed combustion technology. From the potential pool of 4,000 megawatts of capacity, not more than 500 megawatts in total and not more than 250 megawatts in years prior to 2009 shall be allocated to facilities using pressurized fluidized bed combustion technology. From the potential pool of 4,000 megawatts of capacity, not more than 2,000 megawatts in total and not more than 1,000 megawatts in years prior to 2009 and not more than 1,500 megawatts in year prior to 2013 shall be allocated to facilities using integrated gasification combined cycle technology, with or without fuel or chemical co-production. From the potential pool of 4,000 megawatts of capacity, not more than 500 in total and not more than 250 megawatts in years prior to 2009 shall be allocated to any other technology for which a carbon emission rate is not more than 85 percent of conventional technology.

**Production credit for electricity produced from qualifying clean coal technology units**

The proposal provides a production credit for electricity produced from certain facilities that have been retrofitted, repowered, or replaced with a clean coal technology within ten years of the date of enactment. The value of the credit is 0.34 cents per kilowatt-hour of electricity produced and is indexed for inflation occurring after 2002 with the first potential adjustment in 2004. The taxpayer may claim the credit throughout the ten-year period commencing from the date on which the qualifying facility is placed in service.

A qualifying clean coal technology unit is a facility that meets certain capacity standards, thermal efficiency standards, and emissions standards for $SO_2$, nitrous oxides, particulate emissions, and source emissions standards as provided in the Clean Air Act. In addition, a qualifying clean coal technology unit would not be a facility that is receiving or is scheduled to receive funding under the Clean Coal Technology Program, the Power Plant Improvement Initiative, or the Clean Coal Power Initiative administered by the Secretary of the Department of Energy. Lastly, to be a qualified clean coal technology unit, the taxpayer must receive a certificate from the Secretary of the Treasury. The Secretary may grant certificates to facilities only to the point that 4,000 megawatts of electricity production capacity qualifies for the credit. However, no qualifying facility would be eligible if the facility's capacity exceeded 300 megawatts.

**Production credit for electricity produced from qualifying advanced clean coal technology**

The proposal also would provide a production credit for electricity produced from any qualified advanced clean coal technology electricity generation unit that qualifies for the investment credit for qualifying clean coal technology facilities, as described above. The production credit would be claimed on the sum of each kilowatt-hour of electricity produced and

the heat value of other fuels or chemicals produced by the taxpayer at the facility.[2] The production credit would be claimed for the 10-year period commencing with the date the qualifying facility is placed in service. The value of the credit would vary depending upon the year the facility was placed in service, whether the facility produces solely electricity or electricity and fuels or chemicals, and the rated thermal efficiency of the facility. In addition, the value of the credit would be reduced for the second five years of eligible production. The value of the credit would be indexed for inflation occurring after 2002 with the first potential adjustment in 2004. The tables below specify the value of the credit (before indexing is applied).

Advanced clean coal technology facilities producing solely electricity

Facilities placed in service before 2009

| The facility net heat rate, Btu/kWh adjusted for the heat content for the design coal is equal to: | Credit amount per kilowatt-hour | |
|---|---|---|
| | For the first five years | For the second five years |
| Not more than 8,400 | $.0060 | $.0038 |
| More than 8,400 but not more than 8,550 | $.0025 | $.0010 |
| More than 8,550 but less than 8,750 | $.0010 | $.0010 |

Facilities placed in service after 2008 and before 2013

| The facility net heat rate, Btu/kWh adjusted for the heat content for the design coal is equal to: | Credit amount per kilowatt-hour | |
|---|---|---|
| | For the first five years | For the second five years |
| Not more than 7,770 | $.0105 | $.0090 |
| More than 7,770 but not more than 8,125 | $.0085 | $.0068 |
| More than 8,125 but less than 8,350 | $.0075 | $.0055 |

[2] Each 3,413 Btu of heat content of the fuel or chemical is treated as equivalent to one kilowatt-hour of electricity.

Facilities placed in service after 2012 and before 2017

| The facility net heat rate, Btu/kWh adjusted for the heat content for the design coal is equal to: | Credit amount per kilowatt-hour | |
|---|---|---|
| | For the first five years | For the second five years |
| Not more than 7,380 | $.0140 | $.0115 |
| More than 7,380 but not more than 7,720 | $.0120 | $.0090 |

Advanced clean coal technology facilities producing electricity and a fuel or chemical

Facilities placed in service before 2009

| The facility design net thermal efficiency is equal to: | Credit amount per kilowatt-hour | |
|---|---|---|
| | For the first five years | For the second five years |
| Not less than 40.6% | $.0060 | $.0038 |
| Less than 40.6% but not less than 40% | $.0025 | $.0010 |
| Less than 40% but not less than 39% | $.0010 | $.0010 |

Facilities placed in service after 2008 and before 2013

| The facility design net thermal efficiency is equal to: | Credit amount per kilowatt-hour | |
|---|---|---|
| | For the first five years | For the second five years |
| Not less than 43.9% | $.0105 | $.0090 |
| Less than 43.9% but not less than 42% | $.0085 | $.0068 |
| Less than 42% but not less than 40.9% | $.0075 | $.0055 |

Facilities placed in service after 2012 and before 2017

| The facility design net thermal efficiency is equal to: | Credit amount per kilowatt-hour | |
|---|---|---|
| | For the first five years | For the second five years |
| Not less than 44.2% | $.0140 | $.0115 |
| Less than 44.2% but not less than 43.6% | $.0120 | $.0090 |

## Effective Date

The proposal relating to investment credits for advanced clean coal technology facilities would be effective after the date of enactment. The proposals relating to production credits would be effective after the date of enactment.

## V. OIL AND GAS PROVISIONS

### A. Tax Credit for Oil and Gas Production from Marginal Wells

#### Present Law

There is no credit for the production of oil and gas from marginal wells. The costs of such production may be recovered under the Code's depreciation and depletion rules and in other cases as a deduction for ordinary and necessary business expenses.

#### Description of Proposal

The proposal would create a new, $3 per barrel credit for the production of crude oil and a $0.50 credit per 1,000 cubic feet of qualified natural gas production. The maximum amount of production on which credit could be claimed would be 1,095 barrels or barrel equivalents. In both cases, the credit would be available only for production from a "qualified marginal well." The credit would not be available to production occurring if the reference price of oil exceeded $18 ($2.00 for natural gas). The credit would be reduced proportionately as for reference prices between $15 and $18 ($1.67 and $2.00 for natural gas). Reference prices would be determined on a one-year look-back basis.

A qualified marginal well would be defined as (1) a well production from which was marginal production for purposes of the Code percentage depletion rules or (2) a well that during the taxable year had (a) average daily production of not more than 25 barrel equivalents and (b) produced water at a rate of not less than 95 percent of total well effluent.

The credit would be treated as a general business credit.

#### Effective Date

The proposal would be effective for production in taxable years beginning after the date of enactment.

## B. Natural Gas Gathering Lines Treated as Seven-Year Property

### Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[3] Revenue Procedure 87-56 includes two asset classes that could describe natural gas gathering lines owned by nonproducers of natural gas. Asset class 46.0, describing pipeline transportation, provides a class life of 22 years and a recovery period of 15 years. Asset class 13.2, describing assets used in the exploration for and production of petroleum and natural gas deposits, provides a class life of 14 years and a depreciation recovery period of seven years. The uncertainty regarding the appropriate recovery period of natural gas gathering lines has resulted in litigation between taxpayers and the IRS. The 10th Circuit Court of Appeals held that natural gas gathering lines owned by nonproducers falls within the scope of Asset class 13.2 (i.e., 7-year recovery period).[4] More recently, the U.S. District Court for the Eastern District of Michigan, Southern Division, held that natural gas gathering lines owned by nonproducers falls within the scope of Asset class 46.0 (i.e., 15-year recovery period).[5]

### Description of Proposal

The proposal would establish a statutory 7-year recovery period and a class life of 10 years for natural gas gathering lines. A natural gas gathering line would be defined to include any pipe, equipment, and appurtenance that is (1) determined to be a gathering line by the Federal Energy Regulatory Commission, or (2) used to deliver natural gas from the wellhead or a common point to the point at which such gas first reaches (a) a gas processing plant, (b) an interconnection with an interstate transmission line, (c) an interconnection with an intrastate transmission line, or (d) a direct interconnection with a local distribution company, a gas storage facility, or an industrial consumer.

### Effective Date

The proposal would be effective for property placed in service after date of enactment.

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[3] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

[4] *Duke Energy v. Commissioner*, 172 F.3d 1255 (10th Cir. 1999), *rev'g* 109 T.C. 416 (1997). See also *True v. United States*, 97-2 U.S. Tax Cas. (CCH) par. 50,946 (D. Wyo. 1997).

[5] *Saginaw Bay Pipeline Co. v. United States*, 124 F. Supp. 2d 465 (E.D. Mich. 2001).

## C. Repeal of Requirement of Certain Approved Terminals to Offer Dyed Diesel or Kerosene for Nontaxable Purposes

### Present and Prior Law

Excise taxes are imposed on highway motor fuels, including gasoline, diesel fuel, and kerosene, to finance the Highway Trust Fund programs. Subject to limited exceptions, these taxes are imposed on all such fuels when they are removed from registered pipeline or barge terminal facilities, with any tax-exemptions being accomplished by means of refunds to consumers of the fuel. One such exception allows removal of diesel fuel and kerosene without payment of tax if the fuel is destined for a nontaxable use (e.g., use as heating oil) and is indelibly dyed.

Terminal facilities are not permitted to receive and store non-tax-paid motor fuels unless they are registered with the Internal Revenue Service. Under present law, a prerequisite to registration is that if the terminal offers for sale diesel fuel, it must offer both dyed and undyed diesel fuel. Similarly, if the terminal offers for sale kerosene, it must offer both dyed and undyed kerosene. This "dyed-fuel mandate" was enacted in 1997, to be effective on July 1, 1998. Subsequently, the effective date was delayed until July 1, 2000 and delayed again through December 31, 2001.

### Description of Proposal

The proposal would repeal the diesel fuel and kerosene-dyeing mandate.

### Effective Date

The proposal would be effective on January 1, 2002.

## D. Expensing of Capital Costs Incurred and Credit for Production in Complying with Environmental Protection Agency Sulfur Regulations

### Present Law

Taxpayers generally may recover the costs of investments in refinery property through annual depreciation deductions. Present law does not provide a credit for the production of low-sulfur diesel fuel.

### Description of Proposal

The proposal would permit small business refiners to claim an immediate deduction (i.e., expensing) for up to 75 percent of the costs paid or incurred for the purpose of complying with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency.

In addition, the proposal would provide that a small business refiner may claim a credit equal to five cents per gallon for each gallon of low sulfur diesel fuel produced during the period beginning one year after the date of enactment and ending with the date that is one year after the date on which the taxpayer must comply with applicable EPA regulations for the refinery. The total production credit claimed by the taxpayer would be limited to 25 percent of the capital costs incurred to come into compliance with the EPA diesel fuel requirements. No deduction would be allowed to the taxpayer for expenses otherwise allowable as a deduction in an amount equal to the amount of production credit claimed during the taxable year.

For these purposes a small business refiner is a taxpayer who within the business of refining petroleum products employs not more than 1,500 employees directly in refining on business days during a taxable year in which the deduction or production credit is claimed and had an average daily refinery run not exceeding 155,000 barrels per day for the year prior to enactment.

For taxpayers with an average daily refinery run in the year prior to enactment in excess of 155,000 and not greater than 205,000 barrels per day, the proposal would permit otherwise qualifying small business refiners to claim an immediate deduction for a percentage of qualifying capital costs equal to 75 percent less the percentage points determined by the excess of the average daily refinery runs over 155,000 barrels per day divided by 50,000 barrels per day. In addition, for these taxpayers, the limitation on the total production credit that may be claimed is reduced proportionately.

In the case of a qualifying small business refiner that is owned by a cooperative, the cooperative would be allowed to elect to pass any production credits to patrons of the organization.

### Effective Date

The proposal would be effective for expenses paid or incurred after the date of enactment.

## E. Determination of Small Refiner Exception to Oil Depletion Deduction

### Present Law

Present law classifies oil and gas producers as independent producers or integrated companies. The Code provides numerous special tax rules for operations by independent producers. One such rule allows independent producers to claim percentage depletion deductions rather than deducting the costs of their asset, a producing well, based on actual production from the well (i.e., cost depletion).

A producer is an independent producer only if its refining and retail operations are relatively small. For example, an independent producer may not have refining operations the runs from which exceed 50,000 barrels on any day in the taxable year during which independent producer status is claimed.

### Description of Proposal

The proposal would change the refinery limitation on claiming independent producer status from a limit based on actual daily production to a limit based on average daily production for the taxable year. Accordingly, the average daily refinery run for the taxable year could not exceed 50,000 barrels. For this purpose, the taxpayer would calculate average daily refinery run by dividing total production for the taxable year by the total number of days in the taxable year.

### Effective Date

The proposal would be effective for taxable years beginning after December 31, 2002.

## F. Extension of Suspension of Taxable Income Limit With Respect to Marginal Production

### Present Law

#### In general

Depletion, like depreciation, is a form of capital cost recovery. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset--in the case of depletion for oil or gas interests, the mineral reserve itself--is being expended in order to produce income. Certain costs incurred prior to drilling an oil or gas property are recovered through the depletion deduction. These include costs of acquiring the lease or other interest in the property and geological and geophysical costs (in advance of actual drilling).

Depletion is available to any person having an economic interest in a producing property. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place, and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which it must look for a return of its capital.[6] Thus, for example, both working interests and royalty interests in an oil- or gas-producing property constitute economic interests, thereby qualifying the interest holders for depletion deductions with respect to the property. A taxpayer who has no capital investment in the mineral deposit does not possess an economic interest merely because it possesses an economic or pecuniary advantage derived from production through a contractual relation.

##### Cost depletion

Two methods of depletion are currently allowable under the Internal Revenue Code (the "Code"): (1) the cost depletion method, and (2) the percentage depletion method (secs. 611-613). Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

##### Percentage depletion and related income limitations

The Code generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners.[7] Generally, under the percentage depletion method 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year (sec. 613A(c)). The amount deducted generally may not exceed 100 percent of the net income from that property in any year (the "net-income limitation") (sec. 613(a)). By contrast, for any other mineral qualifying for the percentage depletion deduction, such deduction may not exceed 50 percent of the taxpayer's taxable income from the depletable

[6] Treas. Reg. sec. 1.611-1(b)(1).

[7] Sec. 613A.

property. A similar 50-percent net-income limitation applied to oil and gas properties for taxable years beginning before 1991. Section 11522(a) of the Omnibus Budget Reconciliation Act of 1990 prospectively changed the net-income limitation threshold to 100 percent only for oil and gas properties, effective for taxable years beginning after 1990. The 100-percent net-income limitation for marginal wells has been suspended for taxable years beginning after December 31, 1997, and before January 1, 2002.

Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions) (sec. 613A(d)(1)).[8] Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.

A taxpayer is required to determine the depletion deduction for each oil or gas property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost depletion method. If the cost depletion deduction is larger, the taxpayer must utilize that method for the taxable year in question (sec. 613(a)).

**Limitation of oil and gas percentage depletion to independent producers and royalty owners**

Generally, only independent producers and royalty owners (as contrasted to integrated oil companies) are allowed to claim percentage depletion. Percentage depletion for eligible taxpayers is allowed only with respect to up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas (sec. 613A(c)). For producers of both oil and natural gas, this limitation applies on a combined basis.

In addition to the independent producer and royalty owner exception, certain sales of natural gas under a fixed contract in effect on February 1, 1975, and certain natural gas from geopressured brine,[9] are eligible for percentage depletion, at rates of 22 percent and 10 percent, respectively. These exceptions apply without regard to the 1,000-barrel-per-day limitation and regardless of whether the producer is an independent producer or an integrated oil company.

## Description of Proposal

The suspension of the 100-percent net-income limitation for marginal wells would be extended an additional five years, through taxable years beginning before January 1, 2007.

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[8] Amounts disallowed as a result of this rule may be carried forward and deducted in subsequent taxable years, subject to the 65-percent taxable income limitation for those years.

[9] This exception is limited to wells, the drilling of which began between September 30, 1978, and January 1, 1984.

## Effective Date

The proposal would be effective on date of enactment for taxable years after December 31, 2001.

## G. Amortization of Geological and Geophysical Expenditures

### Present Law

#### In general

Geological and geophysical expenditures are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals. A key issue with respect to the tax treatment of such expenditures is whether or not they are capital in nature. Capital expenditures are not currently deductible as ordinary and necessary business expenses, but are allocated to the cost of the property.[10]

Courts have held that geological and geophysical costs are capital, and therefore are allocable to the cost of the property[11] acquired or retained.[12] The costs attributable to such exploration are allocable to the cost of the property acquired or retained. As described further below, IRS administrative rulings have provided further guidance regarding the definition and proper tax treatment of geological and geophysical costs.

#### Revenue Ruling 77-188

In Revenue Ruling 77-188[13] (hereinafter referred to as the "1977 ruling"), the IRS provided guidance regarding the proper tax treatment of geological and geophysical costs. The ruling describes a typical geological and geophysical exploration program as containing the following elements:

- It is customary in the search for mineral producing properties for a taxpayer to conduct an exploration program in one or more identifiable project areas. Each

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[10] Under section 263, capital expenditures are defined generally as any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Treasury regulations define capital expenditures to include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer or (2) to adapt property to a new or different use. Treas. Reg. sec. 1.263(a)-1(b).

[11] "Property" means an interest in a property as defined in section 614 of the Code, and includes an economic interest in a tract or parcel of land notwithstanding that a mineral deposit has not been established or proved at the time the costs are incurred.

[12] See, *e.g.*, *Schermerhorn Oil Corporation v. Commissioner,* 46 B.T.A. 151 (1942). By contrast, section 617 of the Code permits a taxpayer to elect to deduct certain expenditures incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (but not oil and gas). These deductions are subject to recapture if the mine with respect to which the expenditures were incurred reaches the producing stage.

[13] 1977-1 C.B. 76.

project area encompasses a territory that the taxpayer determines can be explored advantageously in a single integrated operation. This determination is made after analyzing certain variables such as (1) the size and topography of the project area to be explored, (2) the existing information available with respect to the project area and nearby areas, and (3) the quantity of equipment, the number of personnel, and the amount of money available to conduct a reasonable exploration program over the project area.

- The taxpayer selects a specific project area from which geological and geophysical data are desired and conducts a reconnaissance-type survey utilizing various geological and geophysical exploration techniques. These techniques are designed to yield data that will afford a basis for identifying specific geological features with sufficient mineral potential to merit further exploration.

- Each separable, noncontiguous portion of the original project area in which such a specific geological feature is identified is a separate "area of interest." The original project area is subdivided into as many small projects as there are areas of interest located and identified within the original project area. If the circumstances permit a detailed exploratory survey to be conducted without an initial reconnaissance-type survey, the project area and the area of interest will be coextensive.

- The taxpayer seeks to further define the geological features identified by the prior reconnaissance-type surveys by additional, more detailed, exploratory surveys conducted with respect to each area of interest. For this purpose, the taxpayer engages in more intensive geological and geophysical exploration employing methods that are designed to yield sufficiently accurate sub-surface data to afford a basis for a decision to acquire or retain properties within or adjacent to a particular area of interest or to abandon the entire area of interest as unworthy of development by mine or well.

The 1977 ruling provides that if, on the basis of data obtained from the preliminary geological and geophysical exploration operations, only one area of interest is located and identified within the original project area, then the entire expenditure for those exploratory operations is to be allocated to that one area of interest and thus capitalized into the depletable basis of that area of interest. On the other hand, if two or more areas of interest are located and identified within the original project area, the entire expenditure for the exploratory operations is to be allocated equally among the various areas of interest.

If no areas of interest are located and identified by the taxpayer within the original project area, then the 1977 ruling states that the entire amount of the geological and geophysical costs related to the exploration is deductible as a loss under section 165. The loss is claimed in the taxable year in which that particular project area is abandoned as a potential source of mineral production.

A taxpayer may acquire or retain a property within or adjacent to an area of interest, based on data obtained from a detailed survey that does not relate exclusively to any discrete property within a particular area of interest. Generally, under the 1977 ruling, the taxpayer

allocates the entire amount of geological and geophysical costs to the acquired or retained property as a capital cost under section 263(a). If more than one property is acquired, it is proper to determine the amount of the geological and geophysical costs allocable to each such property by allocating the entire amount of the costs among the properties on the basis of comparative acreage.

If, however, no property is acquired or retained within or adjacent to that area of interest, the entire amount of the geological and geophysical costs allocable to the area of interest is deductible as a loss under section 165 for the taxable year in which such area of interest is abandoned as a potential source of mineral production.

In 1983, the IRS issued Revenue Ruling 83-105,[14] which elaborates on the positions set forth in the 1977 ruling by setting forth seven factual situations and applying the principles of the 1977 ruling to those situations. In addition, Revenue Ruling 83-105 explains what constitutes "abandonment as a potential source of mineral production."

## Description of Proposal

The proposal would allow geological and geophysical costs incurred in connection with oil and gas exploration in the United States to be amortized over two years.

## Effective Date

The proposal would be effective for geological and geophysical costs paid or incurred in taxable years beginning after December 31, 2002. No inference is intended from the prospective effective date of this proposal as to the proper treatment of pre-effective date geological and geophysical costs.

[14] 1983-2 C.B. 51.

## H. Amortization of Delay Rental Payments

### Present Law

Present law generally requires costs associated with inventory and property held for resale to be capitalized rather than currently deducted as they are incurred. (sec. 263). Oil and gas producers typically contract for mineral production in exchange for royalty payments. If mineral production is delayed, these contracts provide for "delay rental payments" as a condition of their extension. In proposed regulations issued in 2000, the Treasury Department took the position that the uniform capitalization rules of section 263A require delay rental payments to be capitalized.[15]

### Description of Proposal

The proposal would allow delay rental payments incurred in connection with the development of oil or gas within the United States to be amortized over two years.

### Effective Date

The proposal would apply to delay rental payments paid or incurred in taxable years beginning after December 31, 2002. No inference is intended from the prospective effective date of this proposal as to the proper treatment of pre-effective date delay rental payments.

[15] 65 Fed. Reg. 6090 (2000).

## I. Study of Coal Bed Methane

### Present Law

Certain fuels produced from "non-conventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation) per barrel or BTU oil barrel equivalent (sec. 29). Qualified fuels must be produced within the United States.

Qualified fuels include:

(1) oil produced from shale and tar sands;

(2) gas produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and

(3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

In general, the credit is available only with respect to fuels produced from wells drilled or facilities placed in service after December 31, 1979, and before January 1, 1993. An exception extends the January 1, 1993 expiration date for facilities producing gas from biomass and synthetic fuel from coal if the facility producing the fuel is placed in service before July 1, 1998, pursuant to a binding contract entered into before January 1, 1997.

The credit may be claimed for qualified fuels produced and sold before January 1, 2003 (in the case of non-conventional sources subject to the January 1, 1993 expiration date) or January 1, 2008 (in the case of biomass gas and synthetic fuel facilities eligible for the extension period).

### Description of Proposal

The proposal would direct the Secretary of the Treasury to undertake a study of effect sec. 29 has had on the production of coal bed methane. The Secretary's study would be made in conjunction with the study to be undertaken by the Secretary of the Interior on the effects of coal bed methane production on surface and water resources, as provided in section 608 of S. 1766. The study would estimate the total amount of credit claimed annually and in aggregate related to the production of coal bed methane since the enactment of sec. 29. The study would report the annual value of the credit allowable for coal bed methane compared to the average annual wellhead price of natural gas (per thousand cubic feet of natural gas). The study would estimate the incremental increase in production of coal bed methane that has resulted from the enactment of sec. 29. The study would estimate the cost to the Federal government, in terms of the net tax benefits claimed, per thousand cubic feet of incremental coal bed methane produced annually and in aggregate since the enactment of sec. 29.

### Effective Date

The proposal would be effective on the date of enactment.

## J. Refined Coal

### Present Law

Certain fuels produced from "non-conventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation) per barrel or BTU oil barrel equivalent (sec. 29). Qualified fuels must be produced within the United States.

Qualified fuels include:

(1) oil produced from shale and tar sands;

(2) gas produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and

(3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

In general, the credit is available only with respect to fuels produced from wells drilled or facilities placed in service after December 31, 1979, and before January 1, 1993. An exception extends the January 1, 1993 expiration date for facilities producing gas from biomass and synthetic fuel from coal if the facility producing the fuel is placed in service before July 1, 1998, pursuant to a binding contract entered into before January 1, 1997.

The credit may be claimed for qualified fuels produced and sold before January 1, 2003 (in the case of non-conventional sources subject to the January 1, 1993 expiration date) or January 1, 2008 (in the case of biomass gas and synthetic fuel facilities eligible for the extension period).

### Description of Proposal

The proposal would permit taxpayers to claim credit on qualifying liquid, gaseous, or solid synthetic fuels produced from coal (including lignite) from facilities placed in service after date of enactment and before January 1, 2007. A qualifying fuel is a fuel that when burned emits 20 percent less $SO_2$ and nitrogen oxides than the burning of feedstock coal or comparable coal predominantly available in the marketplace as of January 1, 2002, and if the fuel sells at prices at least 50 percent greater than the prices of the feedstock coal or comparable coal. However, no fuel produced from an advanced clean coal facility (as defined in Part IV.A) would qualify as qualifying fuel. The amount of credit would be $3.00 per barrel equivalent. The credit would be allowed for fuel produced during the five-year period beginning on the date the facility is placed in service.

### Effective Date

The proposal would be effective for fuel sold after the date of enactment.

## K. Natural Gas Distribution Lines Treated as Fifteen-Year Property

### Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[16] Natural gas distribution pipelines are assigned a 20-year recovery period and a class life of 35 years.

### Description of Proposal

The proposal would establish a statutory 15-year recovery period and a class life of 20 years for natural gas distribution lines.

### Effective Date

The proposal would be effective for property placed in service after the date of enactment.

[16] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

## VI. PROVISIONS RELATING TO ELECTRIC INDUSTRY RESTRUCTURING

The ultimate structure of the electric service industry when the currently anticipated overall industry restructuring is completed remains highly speculative at the present time. For example, the extent to which transmission activities will be consolidated into regional transmission organizations and the structure of those organizations has not been resolved. In particular, representatives of the Federal Energy Regulatory Commission ("FERC") have stated that FERC is *encouraging* formation of separate regional transmission organizations, but is not *requiring* utilities to divest themselves fully of ownership of their transmission assets when the utilities participate in such arrangements. Further, the role of public power entities, including the extent to which and the circumstances under which these entities legally or economically may be required to participate in open access arrangements, is unresolved.

The proposal recognizes that it is not possible at the present time to design tax provisions that will address an as yet undefined legal and economic industry structures. The proposal would put in place a mechanism to ensure that up-to-date information on tax issues that arise from future developments is available to the Congress so that appropriate changes to the tax law can be considered on a timely basis.

Further, on January 18, 2001, the Treasury Department published temporary and proposed regulations to provide guidance to issuers of governmental bonds for electric output facilities ("the regulations"). The regulations provide significant interim relief for outstanding electric output facility bonds. Because of this interim relief and the aforementioned uncertainty regarding future industry structure, the proposal does not address issues related to issuance of tax-exempt bonds. The proposal does, however, address certain aspects of electric industry restructuring that are known at the present time and for which comparable interim regulatory relief has not been provided -- issues relating to certain transfers of nuclear decommissioning plants by investor-owned utilities ("IOUs") and certain transactions engaged in by rural electric cooperatives.

### A. Ongoing Study and Reports With Regard to Tax Issues Resulting from Future Restructuring Decisions

The proposal would direct the Department of the Treasury (in consultation with FERC) to conduct an ongoing study of tax issues resulting from restructuring of the electric service industry. The Treasury would be directed to report to Congress at least annually, no later than December 31, on tax issues identified since its last report. The first report would be due no later than December 31, 2002. These annual reports would continue until such time as the industry restructuring activities contemplated under the legislation in conjunction with which the proposal is to be considered have been completed.

Among other issues, this ongoing study would be expected to focus on the effect of restructuring on IOU's and cooperatives (e.g., asset divestitures). In addition, the proposal anticipates that the Treasury Department as part of the analysis underlying its ongoing study would review the interim relief provided to certain tax-exempt bonds in the regulations described above. As current uncertainties regarding the electric service industry are resolved, the proposal

anticipates that the Treasury would, in an expeditious manner, adopt regulatory provisions that are consistent with its current regulatory authority under the Code. Where changes in the private business use rules are determined to require legislation, the proposal anticipates that the Treasury would include recommendations on such changes in its annual reports to Congress.

## B. Modification to Special Rules for Nuclear Decommissioning Costs

### Present Law

#### Overview

Special rules dealing with nuclear decommissioning reserve funds were adopted by Congress in the Deficit Reduction Act of 1984 ("1984 Act"), when tax issues regarding the time value of money were addressed generally. Under general tax accounting rules, a deduction for accrual basis taxpayers is deferred until there is economic performance for the item for which the deduction is claimed. However, the 1984 Act contains an exception under which a taxpayer responsible for nuclear powerplant decommissioning may elect to deduct contributions made to a qualified nuclear decommissioning fund for future decommissioning costs. Taxpayers who do not elect this provision are subject to general tax accounting rules.

#### Qualified nuclear decommissioning fund

A qualified nuclear decommissioning fund (a "qualified fund") is a segregated fund established by a taxpayer that is used exclusively for the payment of decommissioning costs, taxes on fund income, management costs of the fund, and for making investments. The income of the fund is taxed at a reduced rate of 20 percent for taxable years beginning after December 31, 1995.[17]

Contributions to a qualified fund are deductible in the year made to the extent that these amounts were collected as part of the cost of service to ratepayers (the "cost of service requirement").[18] Funds withdrawn by the taxpayer to pay for decommissioning costs are included in the taxpayer's income, but the taxpayer also is entitled to a deduction for decommissioning costs as economic performance for such costs occurs.

Accumulations in a qualified fund are limited to the amount required to fund decommissioning costs of a nuclear powerplant for the period during which the qualified fund is in existence (generally post-1984 decommissioning costs of a nuclear powerplant). For this purpose, decommissioning costs are considered to accrue ratably over a nuclear powerplant's estimated useful life. In order to prevent accumulations of funds over the remaining life of a nuclear powerplant in excess of those required to pay future decommissioning costs of such nuclear powerplant and to ensure that contributions to a qualified fund are not deducted more

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[17] As originally enacted in 1984, a qualified fund paid tax on its earnings at the top corporate rate and, as a result, there was no present-value tax benefit of making deductible contributions to a qualified fund. Also, as originally enacted, the funds in the trust could be invested only in certain low risk investments. Subsequent amendments to the provision have reduced the rate of tax on a qualified fund to 20 percent and removed the restrictions on the types of permitted investments that a qualified fund can make.

[18] Taxpayers are required to include in gross income customer charges for decommissioning costs (sec. 88).

rapidly than level funding (taking into account an appropriate discount rate), taxpayers must obtain a ruling from the IRS to establish the maximum annual contribution that may be made to a qualified fund (the "ruling amount"). In certain instances (e.g., change in estimates), a taxpayer is required to obtain a new ruling amount to reflect updated information.

A qualified fund may be transferred in connection with the sale, exchange or other transfer of the nuclear powerplant to which it relates. If the transferee is a regulated public utility and meets certain other requirements, the transfer will be treated as a nontaxable transaction. No gain or loss will be recognized on the transfer of the qualified fund and the transferee will take the transferor's basis in the fund.[19] The transferee is required to obtain a new ruling amount from the IRS or accept a discretionary determination by the IRS.[20]

**Nonqualified nuclear decommissioning funds**

Federal and State regulators may require utilities to set aside funds for nuclear decommissioning costs in excess of the amount allowed as a deductible contribution to a qualified fund. In addition, taxpayers may have set aside funds prior to the effective date of the qualified fund rules.[21] The treatment of amounts set aside for decommissioning costs prior to 1984 varies. Some taxpayers may have received no tax benefit while others may have deducted such amounts or excluded such amounts from income. Since 1984, taxpayers have been required to include in gross income customer charges for decommissioning costs (sec. 88), and a deduction has not been allowed for amounts set aside to pay for decommissioning costs except through the use of a qualified fund. Income earned in a nonqualified fund is taxable to the fund's owner as it is earned.

## Description of Proposal

**Repeal of cost of service requirement**

The proposal would repeal the cost of service requirement for deductible contributions to a nuclear decommissioning fund. Thus, all taxpayers, including unregulated taxpayers, would be allowed a deduction for amounts contributed to a qualified fund.

**Clarify treatment of transfers of qualified funds and deductibility of decommissioning costs**

The proposal would clarify the Federal income tax treatment of the transfer of a qualified fund. No gain or loss would be recognized to the transferor or the transferee as a result of the transfer of a qualified fund in connection with the transfer of the power plant with respect to which such fund was established. In addition, the proposal would provide that all nuclear decommissioning costs are deductible when paid.

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[19] Treas. reg. sec. 1.468A-6.

[20] Treas. reg. sec. 1.468A-6(f).

[21] These funds are generally referred to as "nonqualified funds."

## Effective Date

The proposal would be effective for taxable years beginning after December 31, 2002.

## C. Treatment of Certain Income of Electric Cooperatives

### Present Law

#### In general

Under present law, an entity must be operated on a cooperative basis in order to be treated as a cooperative for Federal income tax purposes. Although not defined by statute or regulation, the two principal criteria for determining whether an entity is operating on a cooperative basis are: (1) ownership of the cooperative by persons who patronize the cooperative; and (2) return of earnings to patrons in proportion to their patronage. The Internal Revenue Service requires that cooperatives must operate under the following principles: (1) subordination of capital to control over the cooperative undertaking and financial benefits from ownership; (2) democratic control by the members of the cooperative; (3) vesting in and allocation among the members of all excess of operating revenues over the expenses incurred to generate revenues in proportion to their participation in the cooperative (patronage); and (4) operation at cost (not operating for profit or below cost).[22]

In general, cooperative members are those who participate in the management of the cooperative and who share in patronage capital. As described below, income from the sale of electric energy by an electric cooperative may be member or non-member income to the cooperative, depending on the membership status of the purchaser. A municipal corporation may be a member or non-member of a cooperative.

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception--the cooperative may exclude from its taxable income distributions of patronage dividends. In general, patronage dividends are the profits of the cooperative that are rebated to its patrons pursuant to a pre-existing obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative.

Except for tax-exempt farmers' cooperatives, cooperatives that are subject to the cooperative tax rules of subchapter T of the Code (sec. 1381, *et seq.*) are permitted a deduction for patronage dividends from their taxable income only to the extent of net income is derived from transactions with patrons who are members of the cooperative (sec. 1382). The availability of such deductions from net income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative.

Cooperatives that qualify as tax-exempt farmers' cooperatives are permitted to exclude patronage dividends from their taxable income to the extent of all net income, including net income derived from transactions with patrons who are not members of the cooperative,

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[22] Announcement 96-24, Proposed Examination Guidelines Regarding Rural Electric Cooperatives, 1996-16 I.R.B. 35.

provided the value of transactions with patrons who are not members of the cooperative does not exceed the value of transaction with patrons who are members of the cooperative (sec. 521).

**Taxation of electric cooperatives exempt from subchapter T**

In general, the cooperative tax rules of subchapter T apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, other tax-exempt organizations, and certain utilities), including tax-exempt farmers' cooperatives (described in sec. 521(b)). However, subchapter T does not apply to an organization that is "engaged in furnishing electric energy, or providing telephone service, to persons in rural areas" (sec. 1381(a)(2)(C)). Instead, electric cooperatives are taxed under rules that were generally applicable to cooperatives prior to the enactment of subchapter T in 1962. Under these rules, an electric cooperative can exclude patronage dividends from taxable income to the extent of all net income of the cooperative, including net income derived from transactions with patrons who are not members of the cooperative.[23]

**Tax exemption of rural electric cooperatives**

Section 501(c)(12) provides an income tax exemption for rural electric cooperatives if at least 85 percent of the cooperative's income consists of amounts collected from members for the sole purpose of meeting losses and expenses of providing service to its members. The Internal Revenue Service takes the position that rural electric cooperatives also must comply with the fundamental cooperative principles described above in order to qualify for tax exemption under section 501(c)(12).[24] The 85-percent test is determined without taking into account any income from qualified pole rentals and cancellation of indebtedness income from the prepayment of a loan under sections 306A, 306B, or 311 of the Rural Electrification Act of 1936 (as in effect on January 1, 1987). The exclusion for cancellation of indebtedness income applies to such income arising in 1987, 1988, or 1989 on debt that either originated with, or is guaranteed by, the Federal Government. Rural electric cooperatives generally are subject to the tax on unrelated trade or business income under Code section 511.

## Description of Proposal

**Treatment of income from open access transactions**

The proposal would provide that income received or accrued by a rural electric cooperative from any "open access transaction" (other than income received or accrued directly or indirectly from a member of the cooperative) is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). The term "open access transaction" is defined as any activity that would be a "permitted open access activity".

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[23] *See* Rev. Rul. 83-135, 1983-2 C.B. 149.

[24] Rev. Rul. 72-36, 1972-1 C.B. 151.

As applied to rural electric cooperatives, the term "permitted open access activity" is defined as--

(1) the provision or sale of transmission services or ancillary services on a nondiscriminatory open access basis: (i) pursuant to an open access transmission tariff filed with and approved by the Federal Energy Regulatory Commission ("FERC") (including acceptable reciprocity tariffs), but only if (in the case of a voluntarily filed tariff) the cooperative files a report with FERC within 90 days of enactment of this provision relating to whether or not the cooperative will join a regional transmission organization ("RTO"); or (ii) under an RTO agreement approved by FERC (including an agreement providing for the transfer of control--but not ownership--of transmission facilities);[25]

(2) the provision or sale of electric energy distribution services or ancillary services on a nondiscriminatory open access basis to end-users served by distribution facilities owned by the cooperative or its members;

(3) the delivery or sale of electric energy on a nondiscriminatory open access basis, provided that such electric energy is generated by a generation facility that is directly connected to distribution facilities owned by the cooperative (or its members) which owns the generation facility.

For purposes of the 85-percent test, the proposal also would provide that income received or accrued by a rural electric cooperative from any "open access transaction" is treated as an amount collected from members for the sole purpose of meeting losses and expenses, for purposes of the 85-percent test, if the income is received or accrued indirectly from a member of the cooperative.

**Treatment of income from nuclear decommissioning transactions**

The proposal would provide that income received or accrued by a rural electric cooperative from any "nuclear decommissioning transaction" also is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). The term "nuclear decommissioning transaction" is defined as--

(1) any transfer into a trust, fund, or instrument established to pay any nuclear decommissioning costs if the transfer is in connection with the transfer of the cooperative's interest in a nuclear powerplant or nuclear powerplant unit;

(2) any distribution from a trust, fund, or instrument established to pay any nuclear decommissioning costs; or

(3) any earnings from a trust, fund, or instrument established to pay any nuclear decommissioning costs.

[25] Under this provision, references to FERC would be treated as including references to the Public Utility Commission of Texas or the Rural Utilities Service.

**Treatment of income from asset exchange or conversion transactions**

The proposal would provide that gain realized by a tax-exempt rural electric cooperative from a voluntary exchange or involuntary conversion of certain property is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). This provision only applies to the extent that: (1) the gain qualifies for deferred recognition under section 1031 (relating to exchanges of property held for productive use or investment) or section 1033 (relating to involuntary conversions); and (2) the replacement property that is acquired by the cooperative pursuant to section 1031 or section 1033 (as the case may be) constitutes property that is used, or to be used, either for the purpose of generating, transmitting, distributing, or selling electricity, or for the purpose of producing, transmitting, distributing, or selling natural gas.

**Treatment of cancellation of indebtedness income from prepayment of certain loans**

The proposal would provide that income from the prepayment of any loan, debt, or obligation of a tax-exempt rural electric cooperative that is originated, insured, or guaranteed by the Federal Government under the Rural Electrification Act of 1936 is excluded in determining whether the cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12).

**Treatment of income from load loss transactions**

Tax-exempt rural electric cooperatives--The proposal would provide that income received or accrued by a tax-exempt rural electric cooperative from a "load loss transaction" is treated under 501(c)(12) as income collected from members for the sole purpose of meeting losses and expenses of providing service to its members. Therefore, income from load loss transactions would be treated as member income in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). The proposal also would provide that income from load loss transactions does not cause a rural electric cooperative to fail to be treated for Federal income tax purposes as a mutual or cooperative company under the fundamental cooperative principles described above.

The term "load loss transaction" would be defined as any wholesale or retail sale of electric energy (other than to a member of the cooperative) to the extent that the aggregate amount of such sales during a seven-year period beginning with the "start-up year" does not exceed the reduction in the amount of sales of electric energy for each year of such period by the cooperative to members. The "start-up year" is defined as the first year: (1) that the cooperative offers nondiscriminatory open access; or (2) in which at least 10 percent of the cooperative's sales of electric energy are to patrons who are not members of the cooperative.

The proposal also would exclude income received or accrued by rural electric cooperatives from load loss transactions from the tax on unrelated trade or business income.

Taxable electric cooperatives--The proposal would provide that similar rules apply to the receipt or accrual of income from load loss transactions of taxable electric cooperatives. For example, income from a load loss transaction would be excludible from the taxable income of a taxable electric cooperative if the cooperative distributes such income pursuant to a pre-existing contract to distribute the income to a patron who is not a member of the cooperative.

## Effective Date

The proposal would be effective for taxable years beginning after the date of enactment.

## VII. EXTENSION OF TAX INCENTIVES FOR INDIAN RESERVATIONS

### A. Extension of Accelerated Depreciation and Wage Credit Benefits on Indian Reservations

#### Present Law

Present law includes the following tax incentives for businesses located within Indian reservations.

**Accelerated depreciation**

With respect to certain property used in connection with the conduct of a trade or business within an Indian reservation, depreciation deductions under section 168(j) will be determined using the following recovery periods:

| | |
|---|---|
| 3-year property | 2 years |
| 5-year property | 3 years |
| 7-year property | 4 years |
| 10-year property | 6 years |
| 15-year property | 9 years |
| 20-year property | 12 years |
| Nonresidential real property | 22 years |

"Qualified Indian reservation property" eligible for accelerated depreciation includes property which is (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation, (2) not used or located outside the reservation on a regular basis, (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer (within the meaning of section 465(b)(3)(C)), and (4) described in the recovery-period table above. In addition, property is not "qualified Indian reservation property" if it is placed in service for purposes of conducting gaming activities. Certain "qualified infrastructure property" may be eligible for the accelerated depreciation even if located outside an Indian reservation, provided that the purpose of such property is to connect with qualified infrastructure property located within the reservation (e.g., roads, power lines, water systems, railroad spurs, and communications facilities).

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax. The accelerated depreciation for Indian reservations is available with respect to property placed in service on or after January 1, 1994, and before January 1, 2004.

**Indian employment credit**

In general, a credit against income tax liability is allowed to employers for the first $20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the employer with respect to certain employees (sec. 45A). The credit is equal to 20 percent of the

excess of eligible employee qualified wages and health insurance costs during the current year over the amount of such wages and costs incurred by the employer during 1993. The credit is an incremental credit, such that an employer's current-year qualified wages and qualified employee health insurance costs (up to $20,000 per employee) are eligible for the credit only to the extent that the sum of such costs exceeds the sum of comparable costs paid during 1993. No deduction is allowed for the portion of the wages equal to the amount of the credit.

Qualified wages means wages paid or incurred by an employer for services performed by a qualified employee. A qualified employee means any employee who is an enrolled member of an Indian tribe or the spouse of an enrolled member of an Indian tribe, who performs substantially all of the services within an Indian reservation, and whose principal place of abode while performing such services is on or near the reservation in which the services are performed. An employee will not be treated as a qualified employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to such employee during the taxable year exceeds an amount determined at an annual rate of $30,000 (adjusted for inflation after 1993).

The wage credit is available for wages paid or incurred on or after January 1, 1994, in taxable years that begin before December 31, 2003.

## Description of Proposal

### Accelerated depreciation

The proposal would extend the accelerated depreciation incentive for two years (to property placed in service before January 1, 2006).

### Indian employment credit

The proposal would extend the Indian employment credit incentive for two years (to taxable years beginning before January 1, 2006).

## Effective Date

The proposal would be effective on the date of enactment.