DESCRIPTION OF THE
"CARE ACT OF 2003"

Scheduled for a Markup
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SENATE COMMITTEE ON FINANCE
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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on February 5, 2003, of the "CARE Act of 2003." This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the "CARE Act of 2003."

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the "CARE Act of 2003"* (JCX-04-03), February 3, 2003.

I. CHARITABLE GIVING INCENTIVES

A. Charitable Deduction for Nonitemizers

Present Law

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3),[2] to certain veterans' organizations, fraternal societies, and cemetery companies,[3] or to a Federal, State, or local governmental entity for exclusively public purposes.[4] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[5]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[6]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[7] In addition, present law requires that any charity that

[2] All section references are to the Internal Revenue Code of 1986, unless otherwise indicated.

[3] Secs. 170(c)(3)-(5).

[4] Sec. 170(c)(1).

[5] Secs. 170(b) and (e).

[6] Sec. 170(a). The Economic Recovery Tax Act of 1981 adopted a temporary provision that permitted individual taxpayers who did not itemize income tax deductions to claim a deduction from gross income for a specified percentage of their charitable contributions. The maximum deduction was $25 for 1982 and 1983, $75 for 1984, 50 percent of the amount of the contribution for 1985, and 100 percent of the amount of the contribution for 1986. The nonitemizer deduction terminated for contributions made after 1986.

[7] Sec. 170(f)(8).

receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[8]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limit may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2003 is $139,500 ($69,750 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

Description of Proposal

In the case of an individual taxpayer who does not itemize deductions, the proposal allows a "direct charitable deduction" from adjusted gross income for charitable contributions paid in cash during the taxable year. This deduction is allowed in addition to the standard deduction. The deduction is available only for that portion of contributions actually made during the year that in the aggregate exceed $250 ($500 in the case of a joint return). The maximum deduction is $250 ($500 in the case of a joint return). Contributions that are below the minimum amount or that exceed the maximum deduction may not be carried over for purposes of a subsequent taxable year's calculation of the direct charitable deduction. Under the proposal, an

[8] Sec. 6115.

individual is not entitled to a charitable deduction for the first $250 of cash contributions made during the tax year, is entitled to a deduction on a dollar-for-dollar basis for contributions of $251 to $500 (e.g., a $1 contribution deduction in the case of $251 of contributions, and a $250 deduction in the case of $500 of contributions), and is not entitled to a deduction for contributions exceeding $500.

The proposal does not alter present-law rules regarding the carryover of contributions to or from a taxable year, including a taxable year in which the taxpayer elects the standard deduction. The direct charitable deduction generally is subject to the tax rules normally governing charitable contribution deductions, such as the substantiation requirements. The deduction is allowed in computing alternative minimum taxable income.

The proposal requires the Secretary of the Treasury to complete a study by December 31, 2004, of the effect of the proposal on increased charitable giving, and of taxpayer compliance, for example, by comparing compliance by taxpayers who itemize their charitable contributions with compliance by those who claim the direct charitable deduction. The Secretary shall report on the study to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives.

Effective Date

The direct charitable deduction is effective for taxable years beginning after December 31, 2002, and before January 1, 2005. The Treasury study is required by December 31, 2004.

B. Tax-Free Distributions From Individual Retirement Arrangements for Charitable Purposes

Present Law

In general

If an amount withdrawn from a traditional individual retirement arrangement ("IRA") or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions.

Charitable contributions

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3),[9] to certain veterans' organizations, fraternal societies, and cemetery companies,[10] or to a Federal, State, or local governmental entity for exclusively public purposes.[11] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[12]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[13]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received

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[9] All section references are to the Internal Revenue Code of 1986, unless otherwise indicated.

[10] Secs. 170(c)(3)-(5).

[11] Sec. 170(c)(1).

[12] Secs. 170(b) and (e).

[13] Sec. 170(a). The Economic Recovery Tax Act of 1981 adopted a temporary provision that permitted individual taxpayers who did not itemize income tax deductions to claim a deduction from gross income for a specified percentage of their charitable contributions. The maximum deduction was $25 for 1982 and 1983, $75 for 1984, 50 percent of the amount of the contribution for 1985, and 100 percent of the amount of the contribution for 1986. The nonitemizer deduction terminated for contributions made after 1986.

from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[14] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[15]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limit may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2003 is $139,500 ($69,750 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either

[14] Sec. 170(f)(8).

[15] Sec. 6115.

retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.[16] Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.[17] For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

IRA rules

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless an exception applies.

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable, until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;[18] (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

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[16] Secs. 170(f), 2055(e)(2), and 2522(c)(2).

[17] Sec. 170(f)(2).

[18] Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

Split-interest trust filing requirements

Split-interest trusts, including charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, are required to file an annual information return[19] (Form 1041A). Trusts that are not split-interest trusts but that claim a charitable deduction for amounts permanently set aside for a charitable purpose[20] also are required to file Form 1041A. The returns are required to be made publicly available.[21] A trust that is required to distribute all trust net income currently to trust beneficiaries in a taxable year is exempt from this return requirement for such taxable year. A failure to file the required return may result in a penalty on the trust of $10 a day for as long as the failure continues, up to a maximum of $5,000 per return.

In addition, split-interest trusts are required to file annually Form 5227.[22] Form 5227 requires disclosure of information regarding a trust's noncharitable beneficiaries. The penalty for failure to file this return is calculated based on the amount of tax owed. A split-interest trust generally is not subject to tax and therefore, in general, a penalty may not be imposed for the failure to file Form 5227. Form 5227 is not required to be made publicly available.

Description of Proposal

Qualified charitable distributions from IRAs

The proposal provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions. Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The present-law rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions.

A qualified charitable distribution is defined as any distribution from an IRA that is made directly by the IRA trustee either to (1) an organization to which deductible contributions can be made (a "direct distribution") or (2) a "split-interest entity." A split-interest entity means a charitable remainder annuity trust or charitable remainder unitrust (together referred to as a "charitable remainder trust"), a pooled income fund, or a charitable gift annuity. Direct distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70-1/2. Distributions to a split interest entity are eligible for the exclusion only if made on or after the date the IRA owner attains age 59-1/2. In the case of split-interest distributions, no person may hold an income interest in the amounts in the split-interest entity attributable to the charitable distribution other than the IRA owner, his or her spouse, or a charitable organization.

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[19] Sec. 6034. This requirement applies to all split-interest trusts described in section 4947(a)(2).

[20] Sec. 642(c).

[21] Sec. 6104(b).

[22] Sec. 6011; Treas. Reg. sec. 53.6011-1(d).

The exclusion applies to direct distributions only if a charitable contribution deduction for the entire distribution otherwise would be allowable, determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution. Similarly, the exclusion applies in the case of a distribution directly to a split-interest entity only if a charitable contribution deduction for the entire present value of the charitable interest (for example, a remainder interest) otherwise would be allowable, determined without regard to the generally applicable percentage limitations.

If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the proposal) and thus is eligible for qualified charitable distribution treatment. In such case, the IRA owner aggregates all IRAs to determine eligibility for the exclusion. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the proposal) if the aggregate balance of all IRAs having the same owners were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are made to reflect the amount treated as a qualified charitable distribution under the special rule.

Special rules apply for distributions to split-interest entities. For distributions to charitable remainder trusts, the proposal provides that subsequent distributions from the charitable remainder trust are treated as ordinary income in the hands of the beneficiary, notwithstanding how such amounts normally are treated under section 664(b). In addition, for a charitable remainder trust to be eligible to receive qualified charitable distributions, the charitable remainder trust has to be funded exclusively by such distributions. For example, an IRA owner may not make qualified charitable distributions to an existing charitable remainder trust any part of which was funded with assets that were not qualified charitable distributions.

Under the proposal, a pooled income fund is eligible to receive qualified charitable distributions only if the fund accounts separately for amounts attributable to such distributions. In addition, all distributions from the pooled income fund that are attributable to qualified charitable distributions are treated as ordinary income to the beneficiary. Qualified charitable distributions to a pooled income fund are not includible in the fund's gross income.

In determining the amount includible in gross income by reason of a payment from a charitable gift annuity purchased with a qualified charitable distribution from an IRA, the portion of the distribution from the IRA used to purchase the annuity is not an investment in the annuity contract.

Any amount excluded from gross income by reason of the proposal is not taken into account in determining the deduction for charitable contributions under section 170.

Qualified charitable distribution examples

The following examples illustrate the determination of the portion of an IRA distribution that is a qualified charitable distribution and the application of the special rules for a qualified charitable distribution to a split-interest entity. In each example, it is assumed that the requirements for qualified charitable distribution treatment are otherwise met (e.g., the applicable age requirement and the requirement that contributions are otherwise deductible) and that no other IRA distributions occur during the year.

Example 1. Individual A has a traditional IRA with a balance of $100,000, consisting solely of deductible contributions and earnings. Individual A has no other IRA. The entire IRA balance is distributed in a direct distribution to a charitable organization. Under present law, the entire distribution of $100,000 would be includible in Individual A's income. Accordingly, under the proposal, the entire distribution of $100,000 is a qualified charitable distribution. As a result, no amount is included in Individual A's income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual A's charitable deduction for the year.

Example 2. The facts are the same as in Example 1, except that the entire IRA balance of $100,000 is distributed to a charitable remainder unitrust, which contains no other assets and which must be funded exclusively by qualified charitable distributions. Under the terms of the trust, Individual A is entitled to receive five percent of the value of the trust each year. As explained in Example l, the entire $100,000 distribution is a qualified charitable distribution, no amount is included in Individual A's income as a result of the distribution, and the distribution is not taken into account in determining the amount of Individual A's charitable deduction for the year. In addition, under a special rule in the proposal for charitable remainder trusts, any distribution from the charitable remainder unitrust to Individual A is includible in gross income as ordinary income, regardless of the character of the distribution under the usual rules for the taxation of distributions from such a trust.

Example 3. Individual B has a traditional IRA with a balance of $100,000, consisting of $20,000 of nondeductible contributions and $80,000 of deductible contributions and earnings. Individual B has no other IRA. In a direct distribution to a charitable organization, $80,000 is distributed from the IRA. Under present law, a portion of the distribution from the IRA would be treated as a nontaxable return of nondeductible contributions. The nontaxable portion of the distribution would be $16,000, determined by multiplying the amount of the distribution ($80,000) by the ratio of the nondeductible contributions to the account balance ($20,000/$100,000). Accordingly, under present law, $64,000 of the distribution ($80,000 minus $16,000) would be includible in Individual B's income.

Under the proposal, notwithstanding the present-law tax treatment of IRA distributions, the distribution is treated as consisting of income first, up to the total amount that would be includible in gross income (but for the proposal) if all amounts were distributed from all IRAs otherwise taken into account in determining the amount of IRA distributions. The total amount that would be includible in income if all amounts were distributed from the IRA is $80,000. Accordingly, under the proposal, the entire $80,000 distributed to the charitable organization is treated as includible in income (before application of the proposal) and is a qualified charitable distribution. As a result, no amount is included in Individual B's income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual B's charitable deduction for the year. In addition, for purposes of determining the tax treatment of other distributions from the IRA, $20,000 of the amount remaining in the IRA is treated as Individual B's nondeductible contributions.

Split-interest trust filing requirements

The proposal increases the penalty on split-interest trusts for failure to file a return and for failure to include any of the information required to be shown on such return and to show the correct information. The penalty is $20 for each day the failure continues up to $10,000 for any one return. In the case of a split-interest trust with gross income in excess of $250,000, the penalty is $100 for each day the failure continues up to a maximum of $50,000. In addition, if a person (meaning any officer, director, trustee, employee, or other individual who is under a duty to file the return or include required information)[23] knowingly failed to file the return or include required information, then that person is personally liable for such a penalty, which would be imposed in addition to the penalty that is paid by the organization. Information regarding beneficiaries that are not charitable organizations as described in section 170(c) is exempt from the requirement to make information publicly available. In addition, the proposal repeals the present-law exception to the filing requirement for split-interest trusts that are required in a taxable year to distribute all net income currently to beneficiaries. Such exception remains available to trusts other than split-interest trusts that are otherwise subject to the filing requirement.

Effective Date

For direct distributions, the proposal is effective for distributions made after the date of enactment. For distributions to a split-interest entity, the proposal is effective for distributions made after December 31, 2003. The proposal relating to information returns of split-interest trusts is effective for returns for taxable years beginning after December 31, 2003.

[23] Sec. 6652(c)(4)(C).

C. Charitable Deduction for Contributions of Food Inventory

Present Law

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory.

However, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis.[24] To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of ongoing disputes between taxpayers and the IRS. In one case, the Tax Court held that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted.[25]

Description of Proposal

Under the proposal, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for donations of food inventory. For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such year from its trade or business (or interest therein) from which contributions are made. For example, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the S corporation, but not the partnership.

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[24] Sec. 170(e)(3). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income. Sec. 170(b)(2).

[25] *Lucky Stores Inc. v. Commissioner*, 105 T.C. 420 (1995).

The 10 percent limitation does not affect the application of the generally applicable percentage limitations. For example, if 10 percent of a sole proprietor's net income from the proprietor's trade or business was greater than 50 percent of the proprietor's contribution base, the available deduction for the taxable year (with respect to contributions to public charities) would be 50 percent of the proprietor's contribution base. Consistent with present law, such contributions may be carried forward because they exceed the 50 percent limitation. Contributions of food inventory by a taxpayer that is not a C corporation that exceed the 10 percent limitation but not the 50 percent limitation could not be carried forward.

For purposes of calculating the enhanced deduction, taxpayers who do not account for inventories under section 471 and who are not required to capitalize indirect costs under section 263A are able to elect to treat the basis of the contributed food as being equal to 25 percent of the food's fair market value.[26]

The proposal changes the amount of the present-law enhanced deduction for eligible contributions of food inventory to the lesser of fair market value or twice the taxpayer's basis in the inventory. For example, a taxpayer who makes an eligible donation of food that has a fair market value of $10 and a basis of $4 could take a deduction of $8 (twice basis). If the taxpayer's basis was $6 instead of $4, then the deduction would be $10 (fair market value). By contrast, under present law, a C corporation's deduction in the first example would be $7 (fair market value less half the appreciation) and in the second example would be $8. (Under present law, taxpayers other than C corporations generally could take a deduction for a contribution of food inventory only for the $4 basis in either example.) Taxpayers that do not account for inventories under section 471 and who are not required to capitalize indirect costs under section 263A would be able to elect to treat the basis of the contributed food as being equal to 25 percent of the food's fair market value.

Under the proposal, the enhanced deduction is available only for food that qualifies as "apparently wholesome food." "Apparently wholesome food" is defined as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

In addition, the proposal provides that the fair market value of donated apparently wholesome food that cannot or will not be sold solely due to internal standards of the taxpayer or lack of market is determined without regard to such internal standards or lack of market and by taking into account the price at which the same or substantially the same food items (as to both type and quality) are sold by the taxpayer at the time of the contribution or, if not so sold at such time, in the recent past.

Effective Date

The proposal is effective for contributions made after the date of enactment.

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[26] This includes, for example, taxpayers who are eligible for administrative relief under Revenue Procedures 2002-28 and 2001-10.

D. Charitable Deduction for Contributions of Book Inventory

Present Law

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory.

However, for certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis.[27] To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must: (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.

Description of Proposal

The proposal modifies the present-law enhanced deduction for C corporations so that it is equal to the lesser of fair market value or twice the taxpayer's basis in the case of qualified book contributions. The proposal provides that the fair market value for this purpose is determined by reference to a bona fide published market price for the book. Under the proposal, a bona fide published market price of a book is a price of a book, determined using the same printing and same edition, published within seven years preceding the contribution, determined as a result of an arm's length transaction, and for which the book was customarily sold. For example, a publisher's listed retail price for a book would not meet the standard if the publisher could not demonstrate to the satisfaction of the Secretary that the price was one at which the book was customarily sold and was the result of an arm's length transaction. If a publisher entered into a contract with a local school district to sell newly published textbooks six years prior to making a qualified book contribution of such textbooks, the publisher could use as a bona fide published market price, the price at which such books regularly were sold to the school district under the contract. By contrast, if a publisher listed in a catalogue or elsewhere a "suggested retail price," but books were not in fact customarily sold at such price, the publisher could not use the "suggested retail price" to determine the fair market value of the book for purposes of the enhanced deduction. Thus, in general, a bona fide published market price must be independently verifiable by reference to actual sales within the seven-year period preceding the contribution, and not to a publisher's own price list.

As an illustration of the mechanics of calculating the enhanced deduction under the proposal, a C corporation that made a qualified book contribution with a bona fide published market price of $10 and a basis of $4 could take a deduction of $8 (twice basis). If the taxpayer's basis is $6 instead of $4, then the deduction is $10. Also, in such latter case, if the

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[27] Sec. 170(e)(3).

book’s bona fide market published market price was $5 at the time of the contribution but was $10 five years before the contribution, then the deduction is $10.

A qualified book contribution means a charitable contribution of books to: (1) an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on; (2) a public library; or (3) an organization described in section 501(c)(3) (except for private nonoperating foundations), that is organized primarily to make books available to the general public at no cost or to operate a literacy program. The donee must: (1) use the property consistent with the donee’s exempt purpose; (2) not transfer the property in exchange for money, other property, or services; and (3) provide the taxpayer a written statement that the donee’s use of the property will be consistent with such requirements and also that the books are suitable, in terms of currency, content, and quantity, for use in the donee’s educational programs and that the donee will use the books in such educational programs.

Effective Date

The proposal is effective for contributions made after the date of enactment.

E. Expand Charitable Contribution Allowed for Scientific Property Used for Research and for Computer Technology and Equipment

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.[28]

Under present law, a taxpayer's deduction for charitable contributions of scientific property used for research and for contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified research contribution" or a "qualified computer contribution."[29] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value minus basis) or (2) two times basis. The enhanced deduction for qualified computer contributions expires for any contribution made during any taxable year beginning after December 31, 2003.

A qualified research contribution means a charitable contribution of inventory that is tangible personal property. The contribution must be to a qualified educational or scientific organization and be made not later than two years after construction of the property is substantially completed. The original use of the property must be by the donee, and be used substantially for research or experimentation, or for research training, in the U.S. in the physical or biological sciences. The property must be scientific equipment or apparatus, constructed by the taxpayer, and may not be transferred by the donee in exchange for money, other property, or services. The donee must provide the taxpayer with a written statement representing that it will use the property in accordance with the conditions for the deduction. For purposes of the enhanced deduction, property is considered constructed by the taxpayer only if the cost of the parts used in the construction of the property (other than parts manufactured by the taxpayer or a related person) do not exceed 50 percent of the taxpayer's basis in the property.

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed the property, not later than the date construction of the property is

[28] Sec. 170(e)(1).

[29] Secs. 170(e)(4) and 170(e)(6).

substantially completed.[30] The original use of the property must be by the donor or the donee,[31] and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed by the taxpayer, the rules applicable to qualified research contributions apply. Contributions may be made to private foundations under certain conditions.[32]

Description of Proposal

Under the proposal, property assembled by the taxpayer, in addition to property constructed by the taxpayer, is eligible for either enhanced deduction.

The proposal extends the enhanced deduction for qualified computer contributions to contributions made before January 1, 2006.

Effective Date

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

[30] If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

[31] This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

[32] Sec. 170(e)(6)(C).

F. Encourage Contributions of Capital Gain Real Property Made for Conservation Purposes

Present Law

Charitable contributions generally

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.[33]

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating or capital loss carrybacks. For individuals, the amount deductible is a percentage of the taxpayer's contribution base, which is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base. Cash contributions to private foundations and certain other organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while also either retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration. Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property, and qualified conservation contributions.

Capital gain property

Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain

[33] Secs. 170, 2055, and 2522, respectively.

property. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

Qualified conservation contributions

Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryover rules of other charitable contributions of capital gain property.

Description of Proposal

In general

Under the proposal, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). Thus, individuals may include the fair market value of any qualified conservation contribution of capital gain property in determining the amount of the charitable contributions subject to the 50-percent contribution base limitation.

Individuals are allowed to carryover any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years. The 50-percent contribution base limitation applies first to contributions other than qualified conservation contributions and then to qualified conservation contributions. For example, assume an individual with a contribution base of $100 makes a qualified conservation contribution of property with a fair market value of $80 and makes other charitable contributions of $60. The individual is allowed a deduction of $50 in the current taxable year for the other contributions (50 percent of the $100 contribution base) and is allowed to carryover the excess $10 for up to 5 years. No current deduction is allowed for the qualified conservation contribution but the entire $80 qualified conservation contribution may be carried forward for up to 15 years.

Farmers and ranchers

In the case of an eligible farmer or rancher, a qualified conservation contribution is allowable up to 100 percent of the taxpayer's contribution base (after taking into account other charitable contributions). This rule applies both to individuals and corporations. In addition, corporate (as well as non-corporate) eligible farmers and ranchers are allowed to carryover any excess qualified conservation contributions for up to 15 years. The 100-percent contribution base limitation applies first to contributions other than qualified conservation contributions (to the extent allowable under other percentage limitations) and then to qualified conservation contributions. For example, assume an individual farmer or rancher with a contribution base of $100 makes a qualified conservation contribution of property with a fair market value of $80 and makes other charitable contributions of $60. The individual is allowed a deduction of $50 in the current taxable year for the other contributions (50 percent of the $100 contribution base) and is allowed to carryover the excess $10 for up to 5 years. The individual also is allowed a deduction of $50 in the current taxable year for the qualified charitable contribution (the amount of the remaining contribution base). The remaining $30 qualified conservation contribution may be carried forward for up to 15 years.

For this purpose, an eligible farmer or rancher means a taxpayer (other than a publicly traded C corporation) whose gross income from the trade of business of farming is at least 51 percent of the taxpayer's gross income for the taxable year.

Effective Date

The proposal is effective for contributions made after the date of enactment.

G. Exclusion of 25 Percent of Capital Gain for Certain Sales Made for Qualifying Conservation Purposes

Present Law

Sales of capital gain property

Gain from the sale or exchange of land held more than one year generally is treated as long-term capital gain. Generally, the net capital gain of an individual (i.e., long-term capital gain less short-term capital loss) is subject to a maximum tax rate of 20 percent.

Charitable contributions of capital gain property for conservation purposes

Special rules apply to charitable contributions of qualified conservation contributions. Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Charitable contributions of interests that constitute the taxpayer's entire interest in the property are not regarded as qualified real property interests within the meaning of section 170(h),[34] but instead are subject to the general rules applicable to charitable contributions of entire interests of the taxpayer. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Treasury regulations provide that a deduction for a qualified conservation contribution is allowed only if the donor prohibits in the instrument of conveyance the donee from subsequently transferring the qualified real property interest, whether or not for consideration, unless the donee organization, as a condition of the subsequent transfer, requires that the conservation purpose which the contribution was originally intended to advance continues to be carried out.[35] Moreover, subsequent transfers of such interests are restricted to organizations that are qualified conservation organizations.[36]

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[34] Ltr. Rul. 8626029.

[35] Treas. Reg. sec. 1.170A-14(c)(2).

[36] *Id*.

Description of Proposal

In general

The proposal provides a 25-percent exclusion from gross income of long-term capital gain from the qualifying sale or exchange of land, or an interest in land or water rights, provided that the land or interest in land or water rights constitutes an interest in real property that has been held by the taxpayer or the taxpayer's family at all times during the five years preceding the date of sale. The qualifying sale must be made to a qualified organization that intends that the acquired property be used for qualified conservation purposes in perpetuity.[37]

Qualifying interests

The exclusion applies only to sales or exchanges of real property interests in land or water rights that constitute the entire interest of the taxpayer in such land or water rights, or that constitute qualified real property interests as defined in section 170(h), specifically: (1) the entire interest of the taxpayer other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use which may be made of the real property. Partial interests in property that are not the entire interest of the taxpayer or a qualified real property interest do not qualify for the exclusion. For example, a taxpayer who owns land and related mineral rights but who sells only the mineral rights is not eligible for the exclusion. However, a taxpayer who owns only mineral rights is eligible for the 25-percent exclusion if the taxpayer sells his or her entire interest in the mineral rights and satisfies the other requirements of the proposal.

Generally, an undivided interest that constitutes the taxpayer's entire interest in the property is eligible for the exclusion. A partial interest that constitutes the taxpayer's entire interest in the property, however, does not qualify for the exclusion if the property in which such partial interest exists was divided in an attempt to avoid the partial interest rules.

Under the proposal, the exclusion is available for long-term capital gain from certain sales or exchanges of stock in a C corporation if the qualified organization ultimately obtains a controlling stock interest (generally a stock interest that provides the qualified organization at least 90 percent of the total voting power and total value of the corporation's stock) and if at least 90 percent of the fair market value of the C corporation's assets at the time of the sale or exchange consists of land or water rights, or interests in land or water rights, that were held by the corporation at all times during the five years preceding the sale. Stock in a corporation will not qualify if at the time of the sale or exchange the fair market value of water rights and infrastructure relating to the delivery of water constitutes more than 50 percent of the fair market

[37] The exclusion is mandatory if all of the requirements of the proposal are satisfied, and a taxpayer need not file an election to take advantage of the exclusion. A taxpayer who transfers qualifying property to a qualified organization may opt out of the 25-percent exclusion by choosing not to satisfy one or more of the proposal's requirements without having to file a formal election with the Secretary, such as by failing to obtain the requisite letter of intent from the qualified organization.

value of all of the corporation's assets. Only a stock interest held by the taxpayer or the taxpayer's family at all times during the five years preceding the sale qualifies for the 25-percent exclusion.

Qualifying gain

The exclusion applies only to long-term capital gain. Gain treated as ordinary income, such as under depreciation recapture provisions, is not eligible for the exclusion. Gain attributable to certain improvements, such as buildings or structures that do not further a qualified conservation purpose ("disqualified improvements"), also does not qualify for the exclusion.[38] The proposal provides that the maximum amount of gain that may be excluded by a shareholder in the case of a sale or exchange of a controlling stock interest is 25 percent of the shareholder's proportionate share of the C corporation's underlying gain attributable to qualifying land, water rights, or interests therein held by the C corporation.

Consistent with present law, the determination of gain or loss is to be calculated on an asset-by-asset basis whenever that is required for other purposes of the Code (such as for purposes of section 1245 or section 1250). In those cases where the Code does not otherwise require a separate determination of gain or loss for the disqualified improvement, the gain allocable to the disqualified improvement shall be determined by reference to the fair market value of the disqualified improvement relative to the fair market value of all assets for which a gain or loss determination is not otherwise required by the Code.[39]

For example, if a taxpayer sells a qualifying land interest with a fair market value of $100 and a basis of $30, that includes a building or structure that does not further a conservation purpose (a disqualified improvement) and that has a fair market value of $40, the taxpayer must determine the portion of the gain that is attributable to the eligible land and to the disqualified improvement. If determination of gain or loss on the sale of the improvement is required for other purposes of the Code, then the gain or loss determined for those purposes governs, and the taxpayer must determine his or her basis of the disqualified improvement (in this case, assumed to be zero), with the result that the $40 gain on the disqualified improvement is not eligible for the 25-percent exclusion and the gain of $30 on the land is eligible for the 25-percent exclusion. On the other hand, if the determination of gain or loss on the sale of the improvement is not required for other purposes of the Code, then the taxpayer shall allocate the aggregate gain of $70 attributable to the land and the disqualified improvement between the land and the improvement on the basis of their respective fair market values (i.e., 40 percent to the improvement and 60 percent to the land). Under this gain allocation rule, the $28 of gain

[38] Soil and water conservation expenditures in the nature of those described in section 175, determined without regard to whether the taxpayer is engaged in a farming business and that the land be used for farming, generally shall be treated as furthering a qualified conservation purpose.

[39] The taxpayer shall be required to use this gain allocation rule unless the taxpayer has adequate records to substantiate the adjusted basis and fair market value to support a separate calculation.

allocable to the improvement is not eligible for the 25-percent exclusion, and the $42 of gain allocable to the land qualifies for the 25-percent exclusion.

Eligible sales

An eligible sale is a sale or exchange (excluding a transfer made by order of condemnation or eminent domain)[40] that may be made only to a qualified organization, defined as a Federal, State, or local government, or an agency or department thereof or a section 501(c)(3) organization that is organized and operated primarily to meet a qualified conservation purpose. In addition, to be an eligible sale, the organization acquiring the property interest must provide the taxpayer with a letter stating that the intent of such organization in acquiring the property is to further a qualified conservation purpose and that any subsequent transfer of the acquired interest will be to a qualified organization and made to protect the conservation purpose in perpetuity. A qualified conservation purpose is: (1) the preservation of land areas for outdoor recreation by, or the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; or (3) the preservation of open space (including farmland and forest land) where the preservation is for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy and will yield a significant public benefit.

Protection of conservation purposes

The proposal provides for the imposition of penalty excise taxes in appropriate cases where a qualified organization fails to take steps consistent with the protection of conservation purposes. If ownership or possession of the property is transferred by a qualified organization other than to another qualified organization, or a legal restriction contained in an instrument of conveyance that protects the qualified conservation purpose is removed, then: (1) a 20-percent excise tax applies to the proceeds or fair market value of the property; (2) any realized gain or income is subject to an additional excise tax imposed at the highest income tax rate applicable to C corporations; and (3) any otherwise applicable non-recognition provisions of the Code shall not apply to the transferor. The excise taxes shall apply to all cases involving the transfer of ownership or possession of the property to a transferee that is not a qualified organization unless the transferring qualified organization demonstrates to the satisfaction of the Secretary that qualified conservation purposes will be protected in perpetuity. In the case of a removal of a legal restriction contained in an instrument of conveyance, the qualified organization must demonstrate to the satisfaction of the Secretary that a later unexpected change in the conditions surrounding the property makes retaining the conservation restriction impossible or impractical and that any proceeds derived from the removal of the restriction will be used to further qualified conservation purposes.

In the case of a transfer by a qualified organization to another qualified organization, the transferee must provide the transferor at the time of the transfer a letter stating that the intent of the transferee is to further a qualified conservation purpose and that any subsequent transfer of

[40] A sale or exchange made prior to the issuance of an order, but that is the result of a threat of condemnation or eminent domain, may qualify for the exclusion.

the acquired interest will be made to protect the conservation purpose in perpetuity, and the transferee becomes subject to the excise tax provisions for subsequent transfers.

The proposal provides that the Secretary may require such reporting as may be necessary or appropriate to further the purpose that any conservation use be in perpetuity.

Relationship with other provisions

In the case of an individual, the exclusion applies both for purposes of the regular tax and the alternative minimum tax. In the case of a corporation, the present-law alternative minimum tax provisions apply without modification.

If a taxpayer sells a real property interest to a qualified organization for less than the property's fair market value, the amount of any charitable contribution deduction is determined in accordance with the bargain sale rules,[41] and the taxpayer shall not fail to qualify for a contribution deduction under those rules solely because the taxpayer derives a tax benefit from the partial exclusion of long-term capital gain from the sale. For example, if a taxpayer sells qualifying land with a fair market value of $100 and an adjusted basis of $10 to a qualified organization for a sales price of $95 (or alternatively, for a sale price of $50), the taxpayer's basis of $10 shall be allocated between the sale and the contribution components of the transfer under the bargain sale rules, and the tax savings resulting from the 25-percent exclusion of long-term capital gain on the sale will not reduce the portion of the transfer treated as a charitable contribution under the bargain sale rules. The present-law requirements applicable to the charitable contribution component of the transfer, including, for example, the recordkeeping, substantiation, and appraisal provisions of Treasury Regulations section 1.170A-13, must be satisfied.

Effective Date

The proposal is effective for sales or exchanges occurring after the date of enactment.

[41] Sec. 1011(b) and Treas. Reg. sec. 1.1011-2.

H. Cost Sharing Payments under the Partners for Fish and Wildlife Program

Present Law

Under present law, gross income does not include the excludable portion of payments made to taxpayers by federal and state governments for a share of the cost of improvements to property under certain conservation programs. These programs include payments received under (1) the rural clean water program authorized by section 208(j) of the Federal Water Pollution Control Act, (2) the rural abandoned mine program authorized by section 406 of the Surface Mining Control and Reclamation Act of 1977, (3) the water bank program authorized by the Water Bank Act, (4) the emergency conservation measures program authorized by title IV of the Agricultural Credit Act of 1978, (5) the agriculture conservation program authorized by the Soil Conservation and Domestic Allotment Act, (6) the great plains conservation program authorized by section 16 of the Soil Conservation and Domestic Policy Act, (7) the resource conservation and development program authorized by the Bankhead-Jones Farm Tenant Act and by the Soil Conservation and Domestic Allotment Act, (8) the forestry incentives program authorized by section 4 of the Cooperative Forestry Assistance Act of 1978, (9) any small watershed program administered by the Secretary of Agriculture which is determined by the Secretary of the Treasury or his delegate to be substantially similar to the type of programs described in items (1) through (8), and (10) any program of a State, possession of the United States, a political subdivision of any of the foregoing, or the District of Columbia under which payments are made to individuals primarily for the purpose of conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

Description of Proposal

The proposal expands the types of qualified cost-sharing payments to include payments under the Partners for Fish and Wildlife Program.

Effective Date

The proposal applies to payments received after the date of enactment.

I. Basis Adjustment to Stock of S Corporation Contributing Property

Present Law

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.[42] A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[43]

Description of Proposal

The proposal provides that the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation will be equal to the shareholder's pro rata share of the adjusted basis of the contributed property.[44]

Thus, for example, assume an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of $200 and a fair market value of $500. The shareholder will be treated as having made a $500 charitable contribution (or a lesser amount if the special rules of section 170(e) apply), and will reduce the basis of the S corporation stock by $200.

Effective Date

The proposal applies to contributions made after the date of enactment.

[42] Sec. 1366(a)(1)(A).

[43] Sec. 1367(a)(2)(B).

[44] *See* Rev. Rul. 96-11 (1996-1 C.B. 140) for a rule reaching a similar result in the case of charitable contributions made by a partnership.

J. Enhanced Deduction for Charitable Contributions of Literary, Musical, Artistic, and Scholarly Compositions

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the deduction generally is limited to the taxpayer's basis in the property.[45] In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions of tangible personal property to a private foundation (other than certain private foundations),[46] the amount of the deduction is limited to the taxpayer's basis in the property.

Under present law, charitable contributions of literary, musical, and artistic compositions created or prepared by the donor are considered ordinary income property and a taxpayer's deduction of such property is limited to the taxpayer's basis (typically, cost) in the property. A charitable contribution of a literary, musical, or artistic composition by a person other than the person who created or prepared the work generally is eligible for a fair market value deduction if the donee organization's use of the property is related to such organization's exempt purposes.

To be eligible for the deduction, the contribution must be of an undivided portion of the donor's entire interest in the property.[47] For purposes of the charitable income tax deduction, the copyright and the work in which the copyright is embodied are not treated as separate property interests. Accordingly, if a donor owns a work of art and the copyright to the work of art, a gift of the artwork without the copyright or the copyright without the artwork will constitute a gift of a "partial interest" and will not qualify for the income tax charitable deduction.

Description of Proposal

The proposal provides that a deduction for "qualified artistic charitable contributions" generally is increased from the value under present law (generally, basis) to the fair market value of the property contributed, measured at the time of the contribution. However, the amount of the increase of the deduction provided by the proposal may not exceed the amount of the donor's adjusted gross income for the taxable year attributable to: (1) income from the sale or use of property created by the personal efforts of the donor that is of the same type as the donated property; and (2) income from teaching, lecturing, performing, or similar activities with respect to such property. In addition, the increase to the present-law deduction provided by the proposal may not be carried over and deducted in other taxable years.

The proposal defines a qualified artistic charitable contribution to mean a charitable contribution of any literary, musical, artistic, or scholarly composition, or similar property, or the

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[45] Sec. 170(e)(1).

[46] Sec. 170(e)(1)(B)(ii).

[47] Sec. 170(f)(3).

copyright thereon (or both) that meets certain requirements. First, the contributed property must have been created by the personal efforts of the donor at least 18 months prior to the date of contribution. Second, the donor must obtain a qualified appraisal of the contributed property, a copy of which is required to be attached to the donor's income tax return for the taxable year in which such contribution is made. The appraisal must include evidence of the extent (if any) to which property created by the personal efforts of the taxpayer and of the same type as the donated property is or has been owned, maintained, and displayed by certain charitable organizations and sold to or exchanged by persons other than the taxpayer, donee, or any related person. Third, the contribution must be made to a public charity or to certain limited types of private foundations. Finally, the use of donated property by the recipient organization must be related to the organization's charitable purpose or function, and the donor must receive a written statement from the organization verifying such use.

Under the proposal, the tangible property and the copyright on such property are treated as separate properties for purposes of the "partial interest" rule; thus, a gift of artwork without the copyright or a copyright without the artwork does not constitute a gift of a partial interest and is deductible. Contributions of letters, memoranda, or similar property that are written, prepared, or produced by or for an individual while the individual is an officer or employee of any person (including a government agency or instrumentality) do not qualify for a fair market value deduction unless the contributed property is entirely personal.

Effective Date

The deduction for qualified artistic charitable contributions applies to contributions made after the date of enactment.

K. Exclusion for Certain Mileage Reimbursements to Charitable Volunteers

Present Law

Unreimbursed out-of-pocket expenditures made incident to providing donated services to a qualified charitable organization -- such as out-of-pocket transportation expenses necessarily incurred in performing donated services -- may constitute an itemized deduction for charitable contributions.[48] No charitable contribution deduction is allowed for traveling expenses (including expenses for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel.[49] In determining the amount treated as a charitable contribution where a taxpayer operates a vehicle in providing services to a charity, the taxpayer either may deduct actual out-of-pocket expenditures or may use the charitable standard mileage rate. The taxpayer may also deduct (under either computation method), any parking fees and tolls incurred in rendering the services, but may not deduct any amount (regardless of the computation method used) for general repair or maintenance expenses, depreciation, insurance, registration fees, etc.

The charitable standard mileage rate is set by statute at 14 cents per mile.[50] The standard mileage rate for charitable purposes is lower that the standard business rate because the charitable rate covers only the out-of-pocket operating expenses (including gasoline and oil) directly related to the use of the car in performing the donated services that a taxpayer may deduct as a charitable contribution. The charitable rate does not include costs that are not deductible as a charitable contribution such as general repair or maintenance expenses, depreciation, insurance, and registration fees. Such costs are, however, included in computing the business standard mileage rate (the rate allowed for business use of an automobile), which is 36 cents per mile.

Volunteer drivers who are reimbursed for mileage expenses have taxable income to the extent the reimbursement exceeds deductible travel expenses. Employees who are reimbursed for mileage expenses under a qualified arrangement that pays a mileage allowance in lieu of reimbursing actual expenses generally have taxable income to the extent the reimbursement exceeds the amount of the business standard mileage rate multiplied by the actual business miles.

Description of Proposal

Under the proposal, reimbursement by an organization described in section 170(c) (including public charities and private foundations) to a volunteer for the costs of using an automobile in connection with providing donated services is excludable from the gross income of the volunteer, provided that (1) the reimbursement does not exceed the business standard mileage rate prescribed for business use (as periodically adjusted), and (2) recordkeeping requirements applicable to deductible business expenses are satisfied. The proposal does not

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[48] Treas. Reg. sec. 1.170A-1(g).

[49] Sec. 170(j).

[50] Sec. 170(i).

permit a volunteer to claim a deduction or credit with respect to excludible expenses. Information reporting required by section 6041 is not required with respect to reimbursements excluded under the proposal.

Effective Date

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

II. PROPOSALS IMPROVING THE OVERSIGHT OF TAX-EXEMPT ORGANIZATIONS

A. Disclosure of Written Determinations

Present Law

In general

Three provisions of present law govern the disclosure of information relating to tax-exempt organizations. First, section 6103 provides a general rule that tax returns and return information generally are not subject to disclosure unless authorized by the Code.[51] Second, in order to allow the public to scrutinize the activities of tax-exempt organizations, section 6104 grants an exception to the confidentiality rule of section 6103 for certain categories of tax-exempt organization documents and information. Third, section 6110 provides that written determinations by the IRS and related background file documents generally are open to public inspection in redacted form. Section 6110 does not apply to any matter to which section 6104 applies.[52]

Disclosure of applications for recognition of tax exemption and annual information returns

Under present law, the IRS is required to make approved applications for recognition of tax-exempt status (and certain related documents)[53] and annual information returns (Form 990 or Form 990-PF) available for public inspection, except that the IRS is not authorized to disclose the names and addresses of contributors (other than contributors to a private foundation).

The Secretary may withhold disclosure of certain information described in an organization's application for tax-exempt status if disclosure would: (1) divulge a trade secret, patent, process, style of work, or apparatus of the organization, and the Secretary determines that such disclosure would harm the organization; or (2) that the Secretary determines would harm the national defense.[54] The organization must apply to the Commissioner for a determination that the disclosure would violate one of these criteria. The organization will be given 15 days to contest an adverse determination before the information is made available for public inspection.[55]

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[51] Sec. 6103(a).

[52] Sec. 6110(l)(1).

[53] Section 6104(a)(1)(A) provides that "any papers submitted in support of" an application for tax-exempt status must be available for inspection. Treasury regulations limit the definition of supporting documents to papers submitted by the organization. Treas. Reg. sec. 301.6104(a)-1(e).

[54] Sec. 6104(a)(1)(D).

[55] Treas. Reg. sec. 301.6104(a)-5(a)(1).

Disclosure of written determinations

Section 6110 provides that the text of any written determination by the IRS and related background file document is open to public inspection.[56] The term "written determination" means a ruling, determination letter, technical advice memorandum, or Chief Counsel advice. Closing agreements, which are final and conclusive written agreements entered into by the IRS and a taxpayer in order to settle the taxpayer's tax liability with respect to a taxable year, do not constitute written determinations.[57]

Before releasing any written determination or background file document, the IRS must delete identifying details of the person about whom the written determination pertains and certain other private information.[58]

The application of section 6110 to guidance relating to tax-exempt organizations is limited to written determinations unrelated to an organization's tax-exempt status. Section 6110(l)(1) provides, "this section shall not apply to any matter to which section 6104 applies." The regulations under section 6110 clarify which matters are within the ambit of section 6104 and, therefore, are not subject to disclosure under section 6110:

> [a]ny application filed with the Internal Revenue Service with respect to the qualification or exempt status of an organization . . .; any document issued by the Internal Revenue Service in which the qualification or exempt status of an organization is . . . granted, denied or revoked or the portion of any document in which technical advice with respect thereto is given to a district director; . . . the portion of any document issued by the Internal Revenue Service in which is discussed the effect on the qualification or exempt status of an organization . . . of proposed transactions by such organization . . . ; and any document issued by the Internal Revenue Service in which is discussed the qualification or status of a [private foundation or private operating foundation].[59]

In addition, the regulations under section 6104 provide that some documents relating to tax exemption that are not open to public inspection under section 6104(a)(1)(A) are nevertheless "within the ambit" of section 6104 for purposes of the disclosure provisions of section 6110.[60]

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[56] Sec. 6110(a). A background file document includes the request for a written determination, any written material submitted by the taxpayer in support of the request, and any communications between the IRS and other persons in connection with the written determination received before issuance of the written determination. Sec. 6110(b)(2).

[57] Sec. 6103(b)(2)(D); sec. 6110(b)(1)(B).

[58] Sec. 6110(c).

[59] Treas. Reg. sec. 301.6110-1(a).

[60] Treas. Reg. sec. 301.6104(a)-1(i).

The regulation explains that the following documents are, therefore, not available for public inspection under either section 6104 or 6110:

(1) unfavorable rulings or determination letters issued in response to applications for tax exemption;

(2) rulings or determination letters revoking or modifying a favorable determination letter;

(3) technical advice memoranda relating to a disapproved application for tax exemption or the revocation or modification of a favorable determination letter;

(4) any letter or document filed with or issued by the IRS relating to whether a proposed or accomplished transaction is a prohibited transaction under section 503;

(5) any letter or document filed with or issued by the IRS relating to an organization's status as a private foundation or private operating foundation, unless the letter or document relates to the organization's application for tax exemption; and

(6) any other letter or document filed with or issued by the IRS which, although it relates to an organization's tax exempt status as an organization described in section 501(c), does not relate to that organization's application for tax exemption.[61]

The effect of these limitations is that written determinations relating to exempt status issues are not released, even in redacted form. The IRS does, however, release under section 6110 written determinations issued to tax-exempt organizations that include issues that clearly are not within the ambit of section 6104, such as the application of the unrelated business income tax to a particular proposed transaction.

Description of Proposal

The proposal provides that the provisions of section 6110 apply to written determinations and related background file documents relating to an organization described in section 501(c) or (d) (including any written determination denying an organization exempt status under such subsection), or to a political organization described in section 527, that are not required to be disclosed by section 6104(a)(1)(A).

Effective Date

The proposal is effective for written determinations issued after the date of enactment.

[61] *Id.*

B. Disclosure of Internet Web Site and Name Under Which Organization Does Business

Present Law

Most types of tax-exempt organizations are required to file annually an information return.[62] The Internal Revenue Code does not specifically require an exempt organization to furnish on the applicable information return any name under which the organization operates or does business, if such name differs from the legal name of the organization, or the organization's Internet web site address, if any.[63]

Description of Proposal

The proposal requires a tax-exempt organization subject to reporting requirements under section 6033(a) to include on its annual return any name under which such organization operates or does business, and the Internet web site address (if any) of such organization.

Effective Date

The proposal applies to returns filed after December 31, 2003.

[62] Sec. 6033(a). *See, e.g.*, Form 990 -- Return of Organization Exempt From Income Tax. An organization that is required to file Form 990, but that has gross receipts of less than $100,000 during its taxable year, and total assets of less than $250,000 at the end of its taxable year, may file Form 990-EZ instead of Form 990. Private foundations are required to file Form 990-PF rather than Form 990.

[63] The IRS requires disclosure of an organization's Internet web site address on Forms 990 and 990-EZ.

C. Modification to Reporting of Capital Transactions

Present Law

Private foundations are required to file an annual information return (Form 990-PF).[64] Part IV of the Form 990-PF requires that private foundations report detailed information regarding the gain or loss from the sale or other disposition of property, including a description of the property sold, how it was acquired (purchase or donation), the date acquired, the date sold, the gross sales price, the amount of depreciation allowed or allowable, and the cost or other basis plus expenses of the sale. Such information generally is required for the IRS to calculate the tax on the private foundation's net investment income. The Form 990-PF is required to be made available to the public.

Description of Proposal

The proposal requires that any information regarding capital gains and losses with regard to securities transactions on a listed exchange that is required to be furnished by private foundations in order to calculate the tax on net investment income be furnished also in summary form.

In addition, information regarding capital gains and losses with regard to securities transactions on a listed exchange required to be filed with the IRS but that is not in summary form is not required to be made available to the public by the IRS or by the private foundation except by the explicit request of a member of the public to the IRS or to the foundation. A member of the public may request disclosure of such information from the Secretary, who shall prescribe the manner of making such request and the manner of disclosure. A member of the public also may request disclosure of the private foundation, which must be made in person or in writing. If the request is made in person, the foundation shall provide a copy of the information immediately and, if the request is made in writing, the foundation shall provide the information within 30 days.

The proposal also provides that private foundations are required to state on the furnished summary that the more detailed description is available upon request.

Effective Date

The proposal applies to returns filed after December 31, 2003.

[64] Sec. 6033(a).

D. Disclosure that Form 990 is Publicly Available

Present Law

Under present law, there is no requirement that the IRS notify the public that the Form 990 is publicly available.

Description of Proposal

The proposal requires the IRS to notify the public in appropriate publications and other materials of the extent to which Form 990, Form 990-EZ, or Form 990-PF are publicly available.

Effective Date

The proposal applies to publications or materials issued or revised after the date of enactment.

E. Disclosure to State Officials of Proposed Actions Related to Section 501(c) Organizations

Present Law

In the case of organizations that are described in section 501(c)(3) and exempt from tax under section 501(a) or that have applied for exemption as an organization so described, present law (sec. 6104(c)) requires the Secretary to notify the appropriate State officer of (1) a refusal to recognize such organization as an organization described in section 501(c)(3), (2) a revocation of a section 501(c)(3) organization's tax-exempt status, and (3) the mailing of a notice of deficiency for any tax imposed under section 507, chapter 41, or chapter 42.[65] In addition, at the request of such appropriate State officer, the Secretary is required to make available for inspection and copying, such returns, filed statements, records, reports, and other information relating to the above-described disclosures, as are relevant to any State law determination. An appropriate State officer is the State attorney general, State tax officer, or any State official charged with overseeing organizations of the type described in section 501(c)(3).

In general, return and return information (as such terms are defined in sec. 6103(b)) is confidential and may not be disclosed or inspected unless expressly provided by law.[66] Present law requires the Secretary to keep records of disclosures and requests for inspection[67] and requires that persons authorized to receive return and return information maintain various safeguards to protect such information against unauthorized disclosure.[68] Willful unauthorized disclosure or inspection of return or return information is subject to a fine and/or imprisonment.[69] The knowing or negligent unauthorized inspection or disclosure of returns or return information gives the taxpayer a right to bring a civil suit.[70] Such present-law protections against unauthorized disclosure or inspection of return and return information do not apply to the disclosures or inspections, described above, that are authorized by section 6104(c).

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[65] The applicable taxes include the termination tax on private foundations; taxes on public charities for certain excess lobbying expenses; taxes on a private foundation's net investment income, self-dealing activities, undistributed income, excess business holdings, investments that jeopardize charitable purposes, and taxable expenditures (some of these taxes also apply to certain non-exempt trusts); taxes on the political expenditures and excess benefit transactions of section 501(c)(3) organizations; and certain taxes on black lung benefit trusts and foreign organizations.

[66] Sec. 6103(a).

[67] Sec. 6103(p)(3).

[68] Sec. 6103(p)(4).

[69] Secs. 7213 and 7213A.

[70] Sec. 7431.

Description of Proposal

The proposal provides that upon written request by an appropriate State officer, the Secretary may disclose: (1) a notice of proposed refusal to recognize an organization as a section 501(c)(3) organization; (2) a notice of proposed revocation of tax-exemption of a section 501(c)(3) organization; (3) the issuance of a proposed deficiency of tax imposed under section 507, chapter 41, or chapter 42; (4) the names, addresses, and taxpayer identification numbers of organizations that have applied for recognition as section 501(c)(3) organizations; and (5) returns and return information of organizations with respect to which information has been disclosed under (1) through (4) above.[71] Disclosure or inspection is permitted for the purpose of, and only to the extent necessary in, the administration of State laws regulating section 501(c)(3) organizations, such as laws regulating tax-exempt status, charitable trusts, charitable solicitation, and fraud. Disclosure or inspection may be made only to or by designated representatives of the appropriate State officer, which does not include any contractor or agent. The Secretary also is permitted to disclose or open to inspection the return and return information of an organization that is recognized as tax-exempt under section 501(c)(3), or that has applied for such recognition, to an appropriate State officer if the Secretary determines that disclosure or inspection may facilitate the resolution of Federal or State issues relating to the tax-exempt status of the organization. For this purpose, appropriate State officer means the State attorney general or any other State official charged with overseeing organizations of the type described in section 501(c)(3).

In addition, the proposal provides that upon the written request by an appropriate State officer, the Secretary may make available for inspection or disclosure returns and return information of an organization described in section 501(c)(2) (certain title holding companies), 501(c)(4) (certain social welfare organizations), 501(c)(6) (certain business leagues and similar organizations), 501(c)(7) (certain recreational clubs), 501(c)(8) (certain fraternal organizations), 501(c)(10) (certain domestic fraternal organizations operating under the lodge system), and 501(c)(13) (certain cemetery companies). Such return and return information is available for inspection or disclosure only for the purpose of, and to the extent necessary in, the administration of State laws regulating the solicitation or administration of the charitable funds or charitable assets of such organizations. Disclosure or inspection may be made only to or by designated representatives of the appropriate State officer, which does not include any contractor or agent. For this purpose, appropriate State officer means the State attorney general and the head of an agency designated by the State attorney general as having primary responsibility for overseeing the solicitation of funds for charitable purposes of such organizations.

In addition, the proposal provides that any return and return information disclosed under section 6104(c) may be disclosed in civil administrative and civil judicial proceedings pertaining to the enforcement of State laws regulating the applicable tax-exempt organization in a manner prescribed by the Secretary. Returns and return information are not to be disclosed under section 6104(c), or in such an administrative or judicial proceeding, to the extent that the Secretary determines that such disclosure would seriously impair Federal tax administration. The proposal

[71] Such returns and return information also may be open to inspection by an appropriate State officer.

makes disclosures of returns and return information under section 6104(c) subject to the disclosure, recordkeeping, and safeguard provisions of section 6103, including the requirements that such information remain confidential (sec. 6103(a)(2)), that the Secretary maintain a permanent system of records of requests for disclosure (sec. 6103(p)(3)), and that the appropriate State officer maintain various safeguards that protect against unauthorized disclosure (sec. 6103(p)(4)). The proposal provides that the willful unauthorized disclosure of returns or return information described in section 6104(c) is a felony subject to a fine of up to $5,000 and/or imprisonment of up to five years (sec. 7213(a)(2)), the willful unauthorized inspection of returns or return information described in section 6104(c) is subject to a fine of up to $1,000 and/or imprisonment of up to one year (sec. 7213A), and provides the taxpayer the right to bring a civil action for damages in the case of knowing or negligent unauthorized disclosure or inspection of such information (sec. 7431(a)(2)).

Effective Date

The proposal is effective on the date of enactment but does not apply to requests made before such date.

F. Expansion of Penalties to Preparers of Form 990

Present Law

Under present law, income tax return preparers are subject to a penalty of $250 with respect to any return if a portion of an understatement of tax liability is due to a position for which there was not a realistic possibility of success on the merits, the preparer knew or reasonably should have known of the position, and the position was not disclosed or was frivolous.[72] In addition, present law imposes a penalty on income tax return preparers of $1,000 with respect to a tax return if a portion of an understatement of tax liability is due to a willful attempt to understate liability or to reckless or intentional disregard of rules or regulations.[73]

Description of Proposal

The proposal provides that a preparer (for compensation) of an information return of an exempt organization is subject to a penalty of $250 if the preparer omits or misrepresents any information with respect to such return that was known or should have been known by the preparer. The penalty does not apply to minor, inadvertent omissions.

In addition, a preparer of such an information return is subject to a penalty of $1,000 if the preparer recklessly or intentionally misrepresents any information or recklessly or intentionally disregards any rule or regulation with respect to such return. With respect to any return, the $1,000 penalty is reduced by the amount of any penalty paid by such person with respect to the return for omissions and misrepresentations (the $250 penalty imposed by the proposal) or a penalty imposed by section 6694.

Effective Date

The proposal is effective for documents prepared after the date of enactment.

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[72] Sec. 6694(a).

[73] Sec. 6694(b).

G. Notification Requirement for Exempt Entities not Currently Required to File an Annual Information Return

Present Law

Under present law, the requirement that an exempt organization file an annual information return does not apply to several categories of exempt organizations. Organizations excepted from the filing requirement include organizations (other than private foundations), the gross receipts of which in each taxable year normally are not more than $25,000.[74] Also exempt from the requirement are churches, their integrated auxiliaries, and conventions or associations of churches; the exclusively religious activities of any religious order; section 501(c)(1) instrumentalities of the United States; section 501(c)(21) trusts; an interchurch organization of local units of a church; certain mission societies; certain church-affiliated elementary and high schools; certain state institutions whose income is excluded from gross income under section 115; certain governmental units and affiliates of governmental units; and organizations that the IRS has relieved from the filing requirement pursuant to its statutory discretionary authority.

Description of Proposal

The proposal provides that organizations that are excused from filing an information return by reason of normally having gross receipts in each taxable year of not more than $25,000 shall furnish to the Secretary annually the legal name of the organization, any name under which the organization operates or does business, the organization's mailing address and Internet web site address (if any), the organization's taxpayer identification number, the name and address of a principal officer, and evidence of the organization's continuing basis for its exemption from the generally applicable information return filing requirements. Upon such organization's termination of existence, the organization is required to furnish notice of such termination.

The proposal provides that if an organization fails to provide the required notice for three consecutive years, the organization's tax-exempt status is revoked. If upon reapplication for tax-exempt status, the organization shows to the satisfaction of the Secretary reasonable cause for failing to file the required annual notices, the organization's tax-exempt status will be reinstated retroactive to the date of revocation. An organization may not challenge under the Code's declaratory judgment procedures (section 7428) a revocation of tax-exemption made pursuant to the proposal. There is no monetary penalty for failure to file the notice. The proposal does not require that the notices be made available to the public under the public disclosure and inspection rules generally applicable to exempt organizations.

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[74] Sec. 6033(a)(2); Treas. Reg. sec. 1.6033-2(a)(2)(i); Treas. Reg. sec. 1.6033-2(g)(1). Sec. 6033(a)(2)(A)(ii) provides a $5,000 annual gross receipts exception from the annual reporting requirements for certain exempt organizations. In Announcement 82-88, 1982-25 I.R.B. 23, the IRS exercised its discretionary authority under section 6033 to increase the gross receipts exception to $25,000, and enlarge the category of exempt organizations that are not required to file Form 990.

The Secretary is required to notify in a timely manner every organization that is subject to the filing requirement of the new filing obligation. The notice shall be by mail, in the case of any organization the identity and address of which is included in the list of exempt organizations maintained by the Secretary, and by Internet or other means of outreach, in the case of any other organization. The Secretary is authorized to publish a list of organizations whose exempt status is revoked under the proposal.

Effective Date

The proposal is effective for notices with respect to annual periods beginning after 2003.

H. Suspension of Tax-Exempt Status of Terrorist Organizations

Present Law

Under present law, the Internal Revenue Service generally issues a letter revoking recognition of an organization's tax-exempt status only after (1) conducting an examination of the organization, (2) issuing a letter to the organization proposing revocation, and (3) allowing the organization to exhaust the administrative appeal rights that follow the issuance of the proposed revocation letter. In the case of an organization described in section 501(c)(3), the revocation letter immediately is subject to judicial review under the declaratory judgment procedures of section 7428. To sustain a revocation of tax-exempt status under section 7428, the IRS must demonstrate that the organization is no longer entitled to exemption. There is no procedure under current law for the IRS to suspend the tax-exempt status of an organization.

To combat terrorism, the Federal government has designated a number of organizations as terrorist organizations or supporters of terrorism under the Immigration and Nationality Act, the International Emergency Economic Powers Act, and the United Nations Participation Act of 1945.

Description of Proposal

The proposal suspends the tax-exempt status of an organization that is exempt from tax under section 501(a) for any period during which the organization is designated or identified by U.S. Federal authorities as a terrorist organization or supporter of terrorism. The proposal also makes such an organization ineligible to apply for tax exemption under section 501(a). The period of suspension runs from the date the organization is first designated or identified to the date when all designations or identifications with respect to the organization have been rescinded pursuant to the law or Executive order under which the designation or identification was made.

The proposal describes a terrorist organization as an organization that has been designated or otherwise individually identified (1) as a terrorist organization or foreign terrorist organization under the authority of section 212(a)(3)(B)(vi)(II) or section 219 of the Immigration and Nationality Act; (2) in or pursuant to an Executive order that is related to terrorism and issued under the authority of the International Emergency Economic Powers Act or section 5 of the United Nations Participation Act for the purpose of imposing on such organization an economic or other sanction; or (3) in or pursuant to an Executive order that refers to the proposal and is issued under the authority of any Federal law if the organization is designated or otherwise individually identified in or pursuant to such Executive order as supporting or engaging in terrorist activity (as defined in section 212(a)(3)(B) of the Immigration and Nationality Act) or supporting terrorism (as defined in section 140(d)(2) of the Foreign Relations Authorization Act, Fiscal Years 1988 and 1989). During the period of suspension, no deduction for any contribution to a terrorist organization is allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522.

No organization or other person may challenge, under section 7428 or any other provision of law, in any administrative or judicial proceeding relating to the Federal tax liability of such organization or other person, the suspension of tax-exemption, the ineligibility to apply for tax-exemption, a designation or identification described above, the timing of the period of suspension, or a denial of deduction described above. The suspended organization may maintain other suits or administrative actions against the agency or agencies that designated or identified the organization, for the purpose of challenging such designation or identification (but not the suspension of tax-exempt status under this provision).

If the tax-exemption of an organization is suspended and each designation and identification that has been made with respect to the organization is determined to be erroneous pursuant to the law or Executive order making the designation or identification, and such erroneous designation results in an overpayment of income tax for any taxable year with respect to such organization, a credit or refund (with interest) with respect to such overpayment shall be made. If the operation of any law or rule of law (including res judicata) prevents the credit or refund at any time, the credit or refund may nevertheless be allowed or made if the claim for such credit or refund is filed before the close of the one-year period beginning on the date that the last remaining designation or identification with respect to the organization is determined to be erroneous.

The proposal directs the IRS to update the listings of tax-exempt organizations to take account of organizations that have had their exemption suspended and to publish notice to taxpayers of the suspension of an organization's tax-exemption and the fact that contributions to such organization are not deductible during the period of suspension.

Effective Date

The proposal is effective on the date of enactment.

III. OTHER CHARITABLE AND EXEMPT ORGANIZATION PROPOSALS

A. Modify Tax on Unrelated Business Taxable Income of Charitable Remainder Trusts

Present Law

Charitable remainder annuity trusts and charitable remainder unitrusts are exempt from Federal income tax for a tax year unless the trust has any unrelated business taxable income for the year. Unrelated business taxable income includes certain debt financed income. A charitable remainder trust that loses exemption from income tax for a taxable year is taxed as a regular complex trust. As such, the trust is allowed a deduction in computing taxable income for amounts required to be distributed in a taxable year, not to exceed the amount of the trust's distributable net income for the year. Taxes imposed on the trust are required to be allocated to corpus.[75]

Distributions from a charitable remainder annuity trust or charitable remainder unitrust are treated in the following order as: (1) ordinary income to the extent of the trust's current and previously undistributed ordinary income for the trust's year in which the distribution occurred, (2) capital gains to the extent of the trust's current capital gain and previously undistributed capital gain for the trust's year in which the distribution occurred, (3) other income (e.g., tax-exempt income) to the extent of the trust's current and previously undistributed other income for the trust's year in which the distribution occurred, and (4) corpus.[76]

In general, distributions to the extent they are characterized as income are includible in the income of the beneficiary for the year that the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the trust's taxable year.[77]

A charitable remainder annuity trust is a trust that is required to pay, at least annually, a fixed dollar amount of at least five percent of the initial value of the trust to a noncharity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity. A charitable remainder unitrust is a trust that generally is required to pay, at least annually, a fixed percentage of at least five percent of the fair market value of the trust's assets determined at least annually to a noncharity for the life of an individual or for a period 20 years or less, with the remainder passing to charity.[78]

A trust does not qualify as a charitable remainder annuity trust if the annuity for a year is greater than 50 percent of the initial fair market value of the trust's assets. A trust does not

[75] Treas. Reg. sec. 1.664-1(d)(2).

[76] Sec. 664(b).

[77] Treas. Reg. sec. 1.664-1(d)(4).

[78] Sec. 664(d).

qualify as a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50 percent. A trust does not qualify as a charitable remainder annuity trust or a charitable remainder unitrust unless the value of the remainder interest in the trust is at least 10 percent of the value of the assets contributed to the trust.

Description of Proposal

The proposal imposes a 100-percent excise tax on the unrelated business taxable income of a charitable remainder trust. This replaces the present-law rule that takes away the income tax exemption of a charitable remainder trust for any year in which the trust has any unrelated business taxable income. Consistent with present law, the tax is treated as paid from corpus. The unrelated business taxable income is considered income of the trust for purposes of determining the character of the distribution made to the beneficiary.

Effective Date

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

B. Modify Tax Treatment of Certain Payments to Controlling Exempt Organizations

Present Law

In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations. However, section 512(b)(13) generally treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization. In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

Under present law, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includable in the latter organization's unrelated business income and are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt).

The Taxpayer Relief Act of 1997 (the "1997 Act") made several modifications to the control requirement of section 512(b)(13). In order to provide transitional relief, the changes made by the 1997 Act do not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment of the 1997 Act (August 5, 1997) if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

Description of Proposal

The proposal provides that the general rule of section 512(b)(13), which includes interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization in the latter organization's unrelated business income to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity, applies only to the portion of payments received or accrued in a taxable year that exceed the amount of the specified payment that would have been paid or accrued if such payment had been determined under the principles of section 482. Thus, if a payment of rent by a controlled subsidiary to its tax-exempt parent organization exceeds fair market value, the excess amount of such payment over fair market value (as determined in accordance with section 482) is included in the parent organization's unrelated business income, to the extent that such excess reduced the net unrelated income (or increased any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt). In addition, the provision imposes a 20-percent penalty on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

The proposal provides that if modifications to section 512(b)(13) made by the 1997 Act did not apply to a contract because of the transitional relief provided by the 1997 Act, then such modifications also do not apply to amounts received or accrued under such contract before January 1, 2001.

Effective Date

The proposal applies to payments received or accrued after December 31, 2000.

C. Simplification of Lobbying Expenditure Limitation

Present Law

In general

An organization does not qualify for tax-exempt status under section 501(c)(3) unless "no substantial part" of the activities of the organization is "carrying on propaganda, or otherwise attempting, to influence legislation," except as provided by section 501(h).[79] Carrying on propaganda and attempting to influence legislation commonly are referred to as "lobbying" activities. Thus, section 501(c)(3) permits a limited amount of lobbying activity without loss of tax-exempt status.

For purposes of determining whether lobbying activities are a substantial part of an organization's overall functions, an organization generally may choose between two standards, the "no substantial part" test of section 501(c)(3) or the "expenditure" test of section 501(h).

Whether an organization meets the "no substantial part" test is based on all the facts and circumstances. There is no statutory or regulatory guidance, and it is not clear whether the determination is based on the organization's activities, its expenditures, or both. Alternatively, under section 501(h), certain organizations described in section 501(c)(3) can elect to be subject to the expenditure test,[80] which consists of bright-line rules that specify the dollar amount of permitted expenditures on lobbying activities.

Consequences of excess lobbying under section 501(h)

Organizations that make a section 501(h) election ("electing charities") are subject to tax if the electing charity makes either "lobbying expenditures" or "grass roots expenditures" in excess of a certain amount established for each type of expenditure for each taxable year. Lobbying expenditures are the sum of grass-roots expenditures and "direct lobbying" expenditures.[81]

The expenditure limits are based on a "lobbying nontaxable amount" for the taxable year and a "grass roots nontaxable amount" for the taxable year. The lobbying nontaxable amount is the lesser of $1 million or an amount determined as a percentage of an organization's exempt purpose expenditures.[82] The grass-roots nontaxable amount is 25 percent of the organization's

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[79] Sec. 501(c)(3).

[80] Organizations that do not make a section 501(h) election are subject to the "no substantial part" test.

[81] Secs. 501(h)(2)(A), 4911(c)(1), 4911(d).

[82] Exempt purpose expenditures generally are expenses incurred for exempt purposes, such as amounts paid to accomplish exempt purposes, administrative expenses such as overhead, lobbying expenses, and certain fundraising expenses. Exempt purpose expenditures do not include, for example, expenses not for exempt purposes, payments of unrelated business income

lobbying nontaxable amount. An electing charity that exceeds either of the spending limitations is subject to a 25 percent tax on the excess. An electing charity that exceeds both of the spending limitations is subject to a 25 percent tax on the greater of the excess of the lobbying expenditures or the grass-roots expenditures.

An electing charity that normally exceeds either of two "ceiling amounts," which are based on the expenditure limits, will lose its tax exemption.[83] The "lobbying ceiling amount" is 150 percent of the electing charity's lobbying nontaxable amount for the taxable year and the "grass roots ceiling amount" is 150 percent of the grass-roots nontaxable amount for the taxable year. For this purpose, "normal" expenditures are calculated based on a four-year averaging mechanism.[84]

Definitions

Grass-roots expenditures are defined as "any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment thereof."[85] For a communication to constitute grass-roots lobbying, it must refer to "specific legislation," reflect a view on such legislation, and encourage the recipient of the communication to take action with respect to such legislation (a "call to action").[86] A communication includes a call to action if it incorporates one of four elements: (1) it urges the recipient to contact a legislator, employee of a government body, or any other government official or employee who may participate in the formulation of legislation with the principal purpose of influencing legislation; (2) it states the address, telephone number, or similar information of a legislator or an employee of a legislative body; (3) it provides a petition, tear-off postcard, or similar device for the recipient to communicate with government officials or employees who participate in the formulation of legislation with the principal purpose of influencing legislation; or (4) it states the position of one or more legislators on the legislation, except that a communication may name the main sponsors of legislation for purposes of identifying the legislation without constituting a call to action.[87] In

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tax, or capital expenses in connection with an unrelated business. See Treas. Reg. sec. 56.4911-4.

[83] Sec. 501(h)(1).

[84] Treas. Reg. sec. 1.501(h)-3.

[85] Secs. 501(h)(2)(C) & 4911(d)(1)(A).

[86] Treas. Reg. sec. 56.4911-2(b)(2)(i).

[87] Treas. Reg. sec. 56.4911-2(b)(2)(iii). The regulations provide that the first three elements constitute "direct" encouragement, whereas the fourth element is "indirect" encouragement. This distinction becomes relevant in determining whether a communication meets one of the prescribed exceptions to lobbying, i.e., an indirect call to action in a grass-roots communication may qualify as "nonpartisan analysis, study or research" (Treas. Reg. sec. 56.4911-2(b)(2)(iv)), and in determining the proper allocation of expenses between grass-roots and direct lobbying. Treas. Reg. sec. 56.4911-5(e).

addition, a communication is presumed to be grass-roots lobbying if the communication is a paid advertisement that: (1) appears in the mass media within two weeks before a vote by a legislative body or committee (but not a subcommittee) on a highly publicized piece of legislation; (2) reflects a view on the general subject of the legislation; and (3) either refers to the legislation or encourages the public to communicate with legislators on the general subject of such legislation.[88] The presumption is rebuttable if the electing charity demonstrates that the timing of the communication was not related to the legislation or that the advertisement was of a type regularly made by the electing charity without regard to the timing of the legislation (a customary course of business exception).[89]

Direct lobbying expenditures are "any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of the legislation" if the principal purpose of the communication is to influence legislation.[90] A communication would constitute direct lobbying only if the communication "refers to specific legislation" and reflects a view on such legislation.

Certain specified activities do not constitute attempts to influence legislation and therefore expenditures for such activities are not subject to the expenditure limits for lobbying expenditures or grass-roots expenditures. In general, such activities include: (1) making available the results of nonpartisan analysis, study, or research; (2) providing technical advice or assistance to a governmental body or to a committee in response to a written request; (3) appearances before, or communications to, any legislative body with respect to a possible decision of such body that might affect the existence of the organization, its powers and duties, tax-exempt status, or the deduction of contributions to the organization (so-called "self-defense" expenditures); (4) certain communications to members of the electing charity; and (5) communications with governmental officials or employees that are not intended to influence legislation.[91]

Special rules for mixed lobbying expenditures

Expenses that serve both direct and grass-roots lobbying purposes, e.g., communications that are sent to members and nonmembers, or "mixed lobbying" expenditures, are subject to special rules. The regulations specify how an electing charity is to allocate mixed lobbying expenditures between direct and grass-roots lobbying purposes.[92] For example, for a mixed lobbying communication that is designed primarily for members (i.e., more than half the recipients are members) and that directly encourages grass-roots lobbying (even if it also

[88] Treas. Reg. sec. 56.4911-2(b)(5)(ii).

[89] *Id.*

[90] Secs. 501(h)(2)(A) and 4911(d)(1)(B) and Treas. Reg. sec. 56.4911-2(b)(1).

[91] Sec. 4911(d)(2).

[92] Treas. Reg. sec. 56.4911-5(e).

encourages direct lobbying), the grass-roots expenditure amount includes all the costs of preparing the material used for purposes of grass-roots lobbying plus the mechanical and distributional costs associated with the communication. If a mixed lobbying communication encourages direct lobbying, but only indirectly encourages grass-roots lobbying, then the entire costs of the communication are allocated based on the proportion of members and nonmembers receiving the communication.

Disclosure of lobbying expenditures

An electing charity must disclose lobbying expenditures annually on Schedule A of Form 990. In order to meet disclosure requirements, electing charities are required to keep detailed records of direct and grass-roots lobbying expenditures. Required records of grass-roots expenditures include: (1) all amounts directly paid or incurred for grass-roots lobbying; (2) payments to other organizations earmarked for grass-roots lobbying; (3) fees and expenses paid for grass-roots lobbying; (4) the printing, mailing, and other costs of reproducing and distributing materials used in grass-roots lobbying; (5) the portion of amounts paid or incurred as current or deferred compensation for an employee's grass-roots lobbying services; (6) any amount paid for out-of-pocket expenditures incurred on behalf of the electing charity for grass-roots lobbying; (7) the allocable portion of administrative, overhead and other general expenditures attributable to grass-roots lobbying; and (8) expenditures for grass-roots lobbying of a controlled organization.[93]

Description of Proposal

The proposal eliminates the separate limitation for grass-roots lobbying expenditures applicable to electing charities. Electing charities remain subject to the overall limitation on lobbying expenditures, which does not change in amount, but electing charities are not required to limit grass roots expenditures as a percentage of overall lobbying. Thus, an electing charity is able to make tax-free any combination of grass-roots and direct lobbying expenditures up to the lobbying non-taxable amount and does not risk loss of tax-exemption as a result of such expenditures until total lobbying expenditures normally exceed the lobbying ceiling amount. For purposes of the section 501(h) election, electing charities are not required to distinguish between grass-roots lobbying and direct lobbying, whether for mixed lobbying expenditures or otherwise.

Effective Date

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

[93] *See* Treas. Reg. sec. 56.4911-6.

D. Expedited Review Process for Certain Tax-Exemption Applications

Present Law

Most organizations that seek tax-exempt status as a charitable organization are required to file an Application for Recognition of Exemption (Form 1023) with the IRS.[94] Organizations that are not required to file Form 1023 include churches, their integrated auxiliaries, and conventions or associations of churches, and any organization (other than a private foundation) that normally has gross receipts of $5,000 or less in a taxable year. Organizations that file Form 1023 within 15 months of the end of the month of the organization's formation will, if the application is approved, be recognized as tax-exempt from the date of formation. The IRS will automatically grant an organization's request for an additional 12-month extension of the 15-month period. Otherwise, exemption normally will be recognized as of the date the application was received by the IRS. In appropriate circumstances, upon written request, the IRS will expedite consideration of applications for tax-exemption. For example, organizations formed to provide relief to victims of disasters or other emergencies often receive expedited consideration.

Description of Proposal

The proposal provides that the Secretary or his delegate shall adopt procedures to expedite consideration of applications for exempt status by organizations that are organized and operated for the primary purpose of providing social services. To be eligible, the organization must: (1) be seeking a contract or grant under a Federal, State, or local program that provides funding for social service programs; (2) establish that tax-exempt status is a condition of applying for such contract or grant; (3) include a completed copy of the contract or grant application with the application for exemption; and (4) meet such other criteria as the Secretary may provide. Organizations that meet the eligibility requirements described above (except for the requirement that tax-exempt status is a condition of the contract or grant application), and that certify that the organization's average annual gross receipts over the four year period preceding the application was not more than $50,000 (or, in the case of an organization in existence less than four years, is not expected to be more than $50,000 during the organization's first four years) are entitled to a waiver of any fee for application of tax-exempt status.

For this purpose, social services is defined as services directed at helping people in need, reducing poverty, improving outcomes of low-income children, revitalizing low-income communities, and empowering low-income families and low-income individuals to become self-sufficient, including: (1) child care services, protective services for children and adults, services for children and adults in foster care, adoption services, services related to the management and maintenance of the home, day care services for adults, and services to meet the special needs of children, older individuals, and individuals with disabilities (including physical, mental, or emotional disabilities); (2) transportation services; (3) job training and related services, and employment services; (4) information, referral, and counseling services; (5) the preparation and delivery of meals, and services related to soup kitchens or food banks; (6) health support services; (7) literacy and mentoring programs; (8) services for the prevention and treatment of

[94] Sec. 508(a).

juvenile delinquency and substance abuse, services for the prevention of crime and the provision of assistance to the victims and the families of criminal offenders, and services related to the intervention in, and prevention of, domestic violence; and (9) services related to the provision of assistance for housing under Federal law. Social services does not include a program having the purpose of delivering educational assistance under the Elementary and Secondary Education Act of 1965 or under the Higher Education Act of 1965.

Effective Date

The proposal applies to applications for tax-exempt status filed after December 31, 2003.

E. Clarification of Definition of Church Tax Inquiry

Present Law

Under present law, the IRS may begin a church tax inquiry only if an appropriate high-level Treasury official reasonably believes, on the basis of the facts and circumstances recorded in writing, that an organization (1) may not qualify for tax exemption as a church, (2) may be carrying on an unrelated trade or business, or (3) otherwise may be engaged in taxable activities.[95] A church tax inquiry is defined as any inquiry to a church (other than an examination) that serves as a basis for determining whether the organization qualified for tax exemption as a church or whether it is carrying on an unrelated trade or business or otherwise is engaged in taxable activities. An inquiry is considered to commence when the IRS requests information or materials from a church of a type contained in church records, other than routine requests for information or inquiries regarding matters that do not primarily concern the tax status or liability of the church itself.

Description of Proposal

The proposal clarifies that the church tax inquiry procedures do not apply to contacts made by the IRS for the purpose of educating churches with respect to the federal income tax law governing tax-exempt organizations. For example, the IRS does not violate the church tax inquiry procedures when written materials are provided to a church or churches for the purpose of educating such church or churches with respect to the types of activities that are not permissible under section 501(c)(3).

Effective Date

The proposal is effective on the date of enactment.

[95] Sec. 7611. Prior to the year 2000 IRS restructuring, the lowest level official who could initiate a church tax inquiry was an IRS Regional Commissioner.

F. Extension of Declaratory Judgment Procedures to Non-501(c)(3) Tax-Exempt Organizations

Present Law

In order for an organization to be granted tax exemption as a charitable entity described in section 501(c)(3), it generally must file an application for recognition of exemption with the IRS and receive a favorable determination of its status. Similarly, for most organizations, a charitable organization's eligibility to receive tax-deductible contributions is dependent upon its receipt of a favorable determination from the IRS. In general, a section 501(c)(3) organization can rely on a determination letter or ruling from the IRS regarding its tax-exempt status, unless there is a material change in its character, purposes, or methods of operation. In cases in which an organization violates one or more of the requirements for tax exemption under section 501(c)(3), the IRS is authorized to revoke an organization's tax exemption, notwithstanding an earlier favorable determination.

In situations in which the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or in which the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its tax status (sec. 7428). Section 7428 provides a remedy in the case of a dispute involving a determination by the IRS with respect to: (1) the initial qualification or continuing qualification of an organization as a charitable organization for tax exemption purposes or for charitable contribution deduction purposes; (2) the initial classification or continuing classification of an organization as a private foundation; (3) the initial classification or continuing classification of an organization as a private operating foundation; or (4) the failure of the IRS to make a determination with respect to (1), (2), or (3). A "determination" in this context generally means a final decision by the IRS affecting the tax qualification of a charitable organization, although it also can include a proposed revocation of an organization's tax-exempt status or public charity classification. Section 7428 vests jurisdiction over controversies involving such a determination in the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims, and the U.S. Tax Court.

Prior to utilizing the declaratory judgment procedure, an organization must have exhausted all administrative remedies available to it within the IRS. An organization is deemed to have exhausted its administrative remedies at the expiration of 270 days after the date on which the request for a determination was made if the organization has taken, in a timely manner, all reasonable steps to secure such determination.

If an organization (other than a section 501(c)(3) organization) files an application for recognition of exemption and receives a favorable determination from the IRS, the determination of tax-exempt status is usually effective as of the date of formation of the organization if its purposes and activities during the period prior to the date of the determination letter were consistent with the requirements for exemption. However, if the organization files an application for recognition of exemption and later receives an adverse determination from the IRS, the IRS may assert that the organization is subject to tax on some or all of its income for open taxable years. In addition, as with charitable organizations, the IRS may revoke or modify an earlier favorable determination regarding an organization's tax-exempt status.

Under present law, a non-charity (i.e., an organization not described in section 501(c)(3)) may not seek a declaratory judgment with respect to an IRS determination regarding its tax-exempt status. The only remedies available to such an organization are to petition the U.S. Tax Court for relief following the issuance of a notice of deficiency or to pay any tax owed and sue for refund in federal district court or the U.S. Court of Federal Claims.

Description of Proposal

The proposal extends declaratory judgment procedures similar to those currently available only to charities under section 7428 to other section 501(c) and 501(d) determinations. The proposal limits jurisdiction over controversies involving such other determinations to the United States Tax Court.[96]

Effective Date

The extension of the declaratory judgment procedures to organizations other than section 501(c)(3) organizations is effective for pleadings filed with respect to determinations (or requests for determinations) made after December 31, 2002.

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[96] This limitation currently applies to declaratory judgments relating to tax qualification for certain employee retirement plans (sec. 7476).

G. Definition of Convention or Association of Churches

Present Law

Under present law, an organization that qualifies as a "convention or association of churches" (within the meaning of sec. 170(b)(1)(A)(i)) is not required to file an annual return,[97] is subject to the church tax inquiry and church tax examination provisions applicable to organizations claiming to be a church,[98] and is subject to certain other provisions generally applicable to churches.[99] The Internal Revenue Code does not define the term "convention or association of churches."

Description of Proposal

The proposal provides that an organization that otherwise is a convention or association of churches does not fail to so qualify merely because the membership of the organization includes individuals as well as churches, or because individuals have voting rights in the organization.

Effective Date

The proposal is effective on the date of enactment.

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[97] Sec. 6033(a)(2)(A)(i).

[98] Sec. 7611(h)(1)(B).

[99] *See, e.g.*, Sec. 402(g)(8)(B) (limitation on elective deferrals); sec. 403(b)(9)(B) (definition of retirement income account); sec. 410(d) (election to have participation, vesting, funding, and certain other provisions apply to church plans); sec. 414(e) (definition of church plan); sec. 415(c)(7) (certain contributions by church plans); sec. 501(h)(5) (disqualification of certain organizations from making the sec. 501(h) election regarding lobbying expenditure limits); sec. 501(m)(3) (definition of commercial-type insurance); sec. 508(c)(1)(A) (exception from requirement to file application seeking recognition of exempt status); sec. 512(b)(12) (allowance of up to $1,000 deduction for purposes of determining unrelated business taxable income); sec. 514(b)(3)(E) (definition of debt-financed property); sec. 3121(w)(3)(A) (election regarding exemption from social security taxes); sec. 3309(b)(1) (application of federal unemployment tax provisions to services performed in the employ of certain organizations); sec. 6043(b)(1) (requirement to file a return upon liquidation or dissolution of the organization); and sec. 7702(j)(3)(A) (treatment of certain death benefit plans as life insurance).

H. Payments by Charitable Organizations to Victims of War on Terrorism

Present Law

In general, organizations described in section 501(c)(3) of the Code are exempt from taxation. Contributions to such organizations generally are tax deductible.[100] Section 501(c)(3) organizations must be organized and operated exclusively for exempt purposes and no part of the net earnings of such organizations may inure to the benefit of any private shareholder or individual. An organization is not organized or operated exclusively for one or more exempt purposes unless the organization serves a public rather than a private interest. Thus, an organization described in section 501(c)(3) generally must serve a charitable class of persons that is indefinite or of sufficient size.

Tax-exempt private foundations are a type of organization described in section 501(c)(3) and are subject to special rules. Private foundations are subject to excise taxes on acts of self-dealing between the private foundation and a disqualified person with respect to the foundation.[101] For example, it is self-dealing if assets of a private foundation are used for the benefit of a disqualified person, such as a substantial contributor to the foundation or a person in control of the foundation, and the benefit is not incidental or tenuous.

Description of Proposal

The proposal provides that organizations described in section 501(c)(3) that make certain payments are not required to make a specific assessment of need for the payments to be related to the purpose or function constituting the basis for the organization's exemption, provided that the organization makes the payments in good faith and uses an objective formula that is consistently applied in making the payments.

The proposal applies to payments to a member of the Armed Forces of the United States (as defined in section 7701(a)(15)), or to a member of such person's immediate family (including spouses, parents, children, and foster children), by reason of the death, injury, wounding, or illness of a member of the Armed Forces of the United States that was incurred as a result of the military response of the United States to the terrorist attacks against the United States on September 11, 2001. As under present law, such payments must be for public and not private benefit and therefore must serve a charitable class. For example, a charitable organization that assists the families of members of the Armed Forces killed in the line of duty may make pro-rata distributions to the families of those killed, even though the specific financial needs of each family are not directly considered. Similarly, if the amount of a distribution is based on the number of dependents of a charitable class of persons killed in the military response to the attacks and this standard is applied consistently among distributions, the specific needs of each recipient do not have to be taken into account. However, it is not appropriate for a charity to make pro-rata payments based on the recipients' living expenses before the harm occurred if the result generally provides significantly greater assistance to persons in a better position to provide

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[100] Sec. 170.

[101] Sec. 4941.

for themselves than to persons with fewer financial resources. Although such a distribution might be based on objective criteria, it is not a reasonable formula for distributing assistance in an equitable manner. Similarly, although specific assessments of need are not required, payments that do not further public purposes are not permitted. The proposal does not change the substantive standards for exemption under section 501(c)(3), including the prohibition on private inurement. The proposal also provides that if a private foundation makes payments under the conditions described above, the payment is not treated as made to a disqualified person for purposes of section 4941.

Effective Date

The proposal applies to payments made after the date of enactment and before September 11, 2004.

I. Increase Percentage Limits for Certain Employer-Related Scholarship Programs

Present Law

Gross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization (sec. 117(a)). For this purpose, a scholarship generally means an amount paid or allowed to, or for the benefit of, a student to aid that student in pursuing studies.[102] However, an amount paid or allowed to, or on behalf of, an individual to enable the individual to pursue studies is not treated as a scholarship if the amount represents compensation for past, present, or future services.[103] The determination of whether an amount is properly treated as a scholarship or compensation for services is made in light of all the relevant facts and circumstances.

Present law imposes excise taxes on the taxable expenditures of a private foundation.[104] A taxable expenditure includes, among other things, any amount paid or incurred by a private foundation as a grant to an individual for travel, study, or other similar purposes by such individual, unless such grant is awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the Secretary.[105] In the case of individual grants to be made as scholarships or fellowships, the private foundation must demonstrate to the satisfaction of the Secretary that the grant: (1) constitutes a scholarship or fellowship which would be subject to the provisions of section 117(a),[106] and (2) is to be used for study at an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.[107]

Private foundations may in the course of their activities make scholarship or fellowship grants to individuals to be used for educational purposes. However, a private foundation's grant program may not be designed or administered to the end of providing compensation, an employment incentive, or an employee fringe benefit to persons employed by the foundation or by another employer (including, for example, employees of a "related" employer organization). Revenue Procedure 76-47 provides advance approval guidelines to determine whether grants made by private foundations under employer-related grant programs to an employee or to a child of an employee of the employer to which the program relates is considered a scholarship or

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[102] Treas. Reg. sec. 1.117-3(a).

[103] Treas. Reg. sec. 1.117-4(c).

[104] Secs. 4945(a) and (b).

[105] Secs. 4945(d)(3) and (g).

[106] For the purpose of section 4945(g), the term "scholarship or fellowship" refers to the provisions of section 117(a) as in effect before the Tax Reform Act of 1986. Sec. 4945(g)(1).

[107] Secs. 4945(g)(1) and 170(b)(1)(A)(ii).

fellowship grant subject to the provisions of section 117(a).[108] To the extent that such grants are considered scholarships or fellowships under these guidelines, the Secretary will assume the grants are not taxable expenditures subject to section 4945 taxes. Educational grants that are not scholarships or fellowships under these guidelines might, depending upon the circumstances, lead to a loss of the private foundation's exempt status.

Under Revenue Procedure 76-47, a grant made under an employer-related grant program that satisfies seven conditions and a percentage test is considered a scholarship or fellowship.[109] Grants awarded to children of employees and to employees are considered as having been awarded under separate programs for purposes of the revenue procedure, regardless of whether they are awarded under separately administered programs. All such grants must satisfy each of the seven conditions to obtain advance approval of the grant program. The percentage test applicable to grants to children of employees requires that the number of grants awarded not exceed either 25 percent of the eligible applicants considered by the selection committee in selecting grant recipients or 10 percent of those eligible for grants (regardless of whether they submitted grant applications). The percentage test applicable to grants to employees requires that the number of grants awarded not exceed 10 percent of eligible applicants considered by the selection committee in selecting grant recipients. If the seven conditions are met, but the relevant percentage test is not satisfied, then the question of whether the grants constitute scholarships or fellowships is based upon all of the facts and circumstances.

Similar requirements and percentage limits apply to determine whether educational loans made by a private foundation under an employer-related loan program are taxable expenditures.[110] If an employer-related program encompasses educational loans and scholarship

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[108] Rev. Proc. 76-47, 1976-2 C.B. 670. The revenue procedure defines an employer-related program as a program that treats some or all of the employees, or children of some or all of the employees, of an employer as a group from which grantees of some or all of the grants will be selected, limits the potential grantees for some or all of the grants to individuals who are employees or children of employees of an employer, or otherwise gives such individuals a preference or priority over others in being selected as grantees.

[109] The seven conditions include: (1) the program must not be used to recruit employees, to induce employees to continue their employment, or to compel a course of action sought by the employer; (2) the selection of grant recipients must be made by a committee consisting of independent individuals; (3) the program must impose identifiable minimum requirements for grant eligibility; (4) the selection of grant recipients must be based solely upon substantial objective standards that are completely unrelated to employment and to the employer's line of business; (5) a grant may not be terminated because the recipient or the recipient's parent terminates employment with the employer; (6) the courses of study for which grants are available must not be limited to those would be of particular benefit to the employer or the foundation; and (7) the terms of the grant and the courses of study for which grants are available must meet all other requirements of section 117 and must be consistent with the disinterested purpose of education for personal benefit rather than for the benefit of the employer or the foundation.

[110] Rev. Proc. 80-39, 1980-2 C.B. 772.

or fellowship grants to the same group of eligible employees or employees' children, the percentage tests applicable to the loan program apply to the total number of individuals receiving combined grants of scholarships, fellowships, and educational loans.[111]

Description of Proposal

The percentage limits set forth in Revenue Procedure 76-47 for grants to children of employees are increased to 35 percent of eligible applicants considered by the selection committee or 20 percent of those eligible for the grants. However, the higher percentage limits are available only if the private foundation meets the other requirements of the Revenue Procedure and demonstrates that the foundation provides a comparable number and aggregate amount of grants during the same grant-program year to individuals who are not such employees, children or dependents of such employees, or affiliated with the employer of such employees. The proposal does not amend the percentage limits for grants to employees, or the percentage limits of Revenue Procedure 80-39 relating to loan programs or programs which encompass both loans and grants.

Effective Date

Revenue Procedure 76-47 is to be amended effective for grants awarded after the date of enactment.

[111] *Id*.

J. Treatment of Certain Hospital Support Organizations in Determining Acquisition Indebtedness

Present Law

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property. However, under an exception, acquisition indebtedness does not include indebtedness incurred by certain qualified organizations to acquire or improve real property. Qualified organizations include pension trusts, educational institutions, and title-holding companies.

Description of Proposal

The proposal expands the exception to the definition of acquisition indebtedness in the case of a qualified hospital support organization. The exception applies to eligible indebtedness (or the qualified refinancing thereof) of the qualified hospital support organization.

A qualified hospital support organization is a supporting organization (under section 509(a)(3)) of a hospital that is an academic health center (under section 119(d)(4)(B)). The assets of the supporting organization have to meet certain requirements. First, more than half of the value of the organization's assets at any time since its organization (1) have to have been acquired, directly or indirectly, by testamentary gift or devise, and (2) have to consist of real property. In addition, the fair market value of the organization's real estate acquired by gift or devise has to exceed 25 percent of the fair market value of all investment assets held by the organization immediately prior to the time that the eligible indebtedness was incurred. These requirements have to be met each time eligible indebtedness was incurred or a qualified refinancing thereof occurs.

Eligible indebtedness means indebtedness secured by real property acquired directly or indirectly by gift or devise, the proceeds of which are used exclusively to acquire a leasehold interest in or to improve or repair the property. A qualified refinancing of eligible indebtedness occurs if the refinancing does not exceed the amount of refinanced eligible indebtedness immediately before the refinancing.

Effective Date

The proposal applies to indebtedness incurred after December 31, 2003.

IV. SOCIAL SERVICES BLOCK GRANT

Present Law

Social Services Block Grant Funding ("SSBG"), also known as "Title XX" (because it is Title XX of the Social Security Act), is a flexible funding stream, providing states with resources to support a variety of social services. SSBG funds can be used to assist the elderly and disabled so that they do not need to enter institutions, to prevent child and elder abuse, to provide child care, to promote and support adoption, and for several other services. There are certain specified limitations so that SSBG cannot fund most medical care, for example, or cash welfare payments. It is a mandatory capped entitlement, distributed by a population-based formula among the states.

States use SSBG in differing ways. Much of the funding supports local social service providers, including faith-related organizations, through contracts with state and local governments. Overall, in fiscal year 1999, SSBG spending was as follows: 13.4 percent for "prevention" and case management; 13 percent for day care; 12.4 percent for child and adult protective services; 10.9 percent for foster care; 7.4 percent for home-based services. There are several other categories in the expenditure data as well.

Prior to the 1996 welfare reform law, SSBG was funded at $2.8 billion. That legislation reduced SSBG to $2.38 billion, as part of achieving budgetary savings, and permitted states to transfer up to 10 percent of their new Temporary Assistance for Needy Families (TANF) welfare block grant allocations to SSBG. (Any transferred funds are required to be spent on behalf of families below 200 percent of poverty.) In 1998, as part of the TEA-21 highway legislation, SSBG funding as further reduced, declining to $1.7 billion for fiscal year 2001 and fiscal year 2002. The TANF transfer was further limited to 4.25 percent.

Description of Proposal

The proposal increases SSBG funding to $1.975 billion for fiscal year 2003 and $2.8 billion for fiscal year 2004. In addition, the TANF transfer limit is restored to 10 percent. These two measures provide additional resources to faith-related social service organizations. Finally, the Secretary of HHS is required to submit annual reports on SSBG expenditures to the Congress.

Effective Date

The proposal is effective for amounts made available for fiscal year 2003 and for amounts made available each fiscal year thereafter. The proposal requiring annual reports applies to such reports with respect to fiscal year 2002 and each fiscal year thereafter.

V. INDIVIDUAL DEVELOPMENT ACCOUNTS

Present Law

Individual development accounts were first authorized by the Personal Work and Responsibility Act of 1996. In 1998, the Assets for Independence Act established a five-year $125 million demonstration program to permit certain eligible individuals to open and make contributions to an individual development account. Contributions by an individual to an individual development account do not receive a tax preference but are matched by contributions from a State program, a participating nonprofit organization, or other "qualified entity." The IRS has ruled that matching contributions by a qualified entity are a gift and not taxable to the account owner.[112] The qualified entity chooses a matching rate, which must be between 50 and 400 percent. Withdrawals from individual development accounts can be made for certain higher education expenses, a first home purchase, or small-business capitalization expenses. Matching contributions (and earnings thereon) typically are held separately from the individuals' contributions (and earnings thereon) and must be paid directly to a mortgage provider, university, or business capitalization account at a financial institution. The Department of Health and Human Services administers the individual development account program.

Description of Proposal

The proposal provides for a nonrefundable tax credit for an eligible entity (i.e., a qualified financial institution) that has an individual development account program in a taxable year. The tax credit equals the amount of matching contributions made by the eligible entity under the program (up to $500 per taxable year) plus $50 for each individual development account maintained during the taxable year under the program. Except in the first year that each account is open, the $50 credit is available only for accounts with a balance of more than $100 at year-end (including matching funds). The $50 credit is limited to seven years (the year the account is created and the six years immediately thereafter). The credit for matching funds is not allowed with respect to an individual's account if such individual has outstanding student loans, child support payments, or Federal tax liability. No deduction or other credit is available with respect to the amount of matching funds taken into account in determining the credit.

The credit applies with respect to the first 300,000 individual development accounts opened before January 1, 2012, and with respect to matching funds for participant contributions that are made after December 31, 2004, and before January 1, 2012. An account is considered open if at any time the balance in the account exceeds $100 (including matching amounts). The maximum amount of annual contributions to an individual development account by an otherwise eligible individual is limited to three times the maximum credit amount for matching contributions for such year. The individual development accounts will be available on the following basis: (1) a maximum of 100,000 accounts may be opened after December 31, 2004 and before January 1, 2008; (2) a second 100,000 accounts may be opened after December 31, 2007 and before January 1, 2010, if the entire 100,000 of authorized accounts are opened after December 31, 2004 and before January 1, 2008 and the Secretary of the Treasury determines that

[112] Rev. Rul. 99-44, 1999-2 C.B. 549.

these accounts are being reasonably and responsibly administered;[113] and (3) a third 100,000 accounts may be opened after December 31, 2009 and before January 1, 2012 if the previous cohorts of 100,000 accounts have been opened under the schedule described above and the Secretary of the Treasury makes a four-part determination. Specifically, the Secretary will have to determine: (1) that all previously opened accounts have been reasonably and responsibly administered to date; (2) that the individual development account program has increased net savings of participants in the program; (3) whether participants in the individual development account program have increased Federal income tax liability and decreased utilization of Federal assistance programs (e.g., Temporary Assistance to Needy Families and Food Stamps) relative to similarly situated individuals that did not participate in the individual development account program; and (4) that the sum of the increased Federal tax liability and reduction of Federal assistance program benefits to participants in the individual development account program is greater than the cost of the individual development account program to the Federal government. If the Secretary finds that any of the four determinations has not been satisfied, the Congress will have the discretion to authorize the third 100,000 accounts after the Secretary makes his or her report to the Congress regarding the four determinations. The third 100,000 accounts must be equally divided among the States. For all accounts, the Secretary will take steps to encourage use of individual development accounts in rural areas.

Nonstudent U.S. citizens or lawful permanent residents between the ages of 18 and 60 (inclusive) who meet certain income requirements are eligible to open and contribute to an individual development account. The income limit for participation is modified adjusted gross income of $18,000 for single filers, $38,000 for joint filers, and $30,000 for head-of-household filers.[114] Eligibility in a taxable year generally is based on the previous year's modified adjusted gross income and circumstances (e.g., status as a student). Modified adjusted gross income is adjusted gross income plus certain items that are not includible in gross income. The items added are tax-exempt interest and the amounts otherwise excluded from gross income under Code sections 86, 893, 911, 931, and 933 (relating to the exclusion of certain social security and Tier 1 railroad retirement benefits; the exclusion of compensation of employees of foreign governments and international organizations; the exclusion of income of U.S. citizens or residents living abroad; the exclusion of income for residents of Guam, American Samoa, and the Northern Mariana Islands; and the exclusion of income for residents of Puerto Rico). The income limits are adjusted for inflation after 2003. These amounts are rounded to the nearest multiple of 50 dollars.

Under the proposal, an individual development account must: (1) be owned by the eligible individual for whom the account was established; (2) consist only of cash contributions; (3) be held by a person authorized to be a trustee of any individual retirement account under

[113] If less than 100,000 accounts are opened before January 1, 2008, then the number of accounts that can be opened after December 31, 2007 and before January 1, 2010 will be reduced to the lesser of 75,000 accounts or three times the number of accounts opened before January 1, 2007.

[114] Married taxpayers filing separate returns are not eligible to open an IDA or to receive matching funds for an IDA that is already open.

section 408(a)(2); and (4) not commingle account assets with other property (except in a common trust fund or common investment fund). These requirements must be reflected in the written governing instrument creating the account. The entity establishing the program is required to maintain separate accounts for the individual's contributions (and earnings thereon) and for matching funds and earnings thereon (a "parallel account").

Contributions to individual development accounts by individuals are not deductible and earnings thereon are taxable to the account holder. Matching contributions and earnings thereon are not taxable to the account holder. Any amount (including earnings) in an individual development account and matching contributions are disregarded for purposes of any means-tested Federal programs.

The proposal permits individuals to withdraw amounts from an individual development account for qualified expenses of the account owner, owner's spouse, or dependents as well as for nonqualified expenses, subject to certain restrictions. Qualified expenses include qualified: (1) higher education expenses (as generally defined in section 529(e)(3))**;** (2) first-time homebuyer costs (as generally provided in section 72 (t)(8)); (3) business capitalization or expansion costs (expenditures made pursuant to a business plan that has been approved by the financial institution); (4) rollovers of the balance of the account (including the parallel account) to another individual development account for the benefit of the same owner; and (5) final distributions in the case of a deceased account owner. Withdrawals for qualified expenses must be made from funds that have been in the account for at least one year and must be paid directly to the unrelated third party to whom the amount is due, except in the case of expenses under a qualified business plan, rollover, or final distribution. Such withdrawals generally are not permitted until the account owner completes a financial education course offered by a qualified financial institution. The Secretary of the Treasury (the "Secretary") is required to establish minimum standards for such courses. Withdrawals for nonqualified expenses may result in the account owner's forfeiture of matching funds. The amount of the forfeiture is the lesser of: (1) an amount equal to the nonqualified withdrawal; or (2) the excess of the amount in the parallel account (excluding earnings on matching funds) over the amount remaining in the individual development account after the nonqualified withdrawal. If the individual development account (or a portion thereof) is pledged as security for a loan, then the portion so used will be treated as a nonqualified withdrawal and will result in the loss of an equal amount of matching funds from the parallel account. At age 65, an individual may withdraw the balance of his or her individual development account for nonqualified purposes without losing matching amounts.

The qualified entity administering the individual development account program generally is required to make quarterly payments of matching funds to a parallel account on a dollar-for-dollar basis for the first $500 contributed by the account owner in a taxable year. Matching funds also may be provided by State, local, or private sources. Balances of the individual development account and parallel account must be reported annually to the account owner. If an account owner ceases to meet eligibility requirements, matching funds generally may not be contributed during the period of ineligibility. Any amount withdrawn from a parallel account is not includible in an eligible individual's gross income or the account sponsor's gross income.

Qualified entities administering a qualified program are required to report to the Secretary that the program is administered in accordance with legal requirements. If the

Secretary determines that the program was not so operated, the Secretary would have the power to terminate the program. Qualified entities also are required to report annually to the Secretary information about: (1) the number of individuals making contributions to individual development accounts; (2) the amounts contributed by such individuals; (3) the amount of matching funds contributed; (4) the amount of funds withdrawn and for what purpose; (5) balance information; and (6) any other information that the Secretary deems necessary. The fiduciary requirements of Title 12 of the United States Code with respect to insured depository institutions and insured credit unions (as defined therein) continue to apply to those financial institutions participating in the individual development account program. Qualified entities are prohibited from charging any fees with regard to the individual development accounts.

The Secretary is authorized to prescribe necessary regulations, including rules to permit individual development account program sponsors to verify eligibility of individuals seeking to open accounts and rules to allow a financial institution (e.g., a tax-exempt credit union) to transfer those credits to another taxpayer. The Secretary also is authorized to provide rules to recapture credits claimed with respect to individuals who forfeit matching funds.

The Secretary must submit annual reports to Congress on the status of the qualified individual account program.

Effective Date

The proposal is effective for taxable years ending after December 31, 2004, and beginning before January 1, 2012.

VI. AUTHORIZATION OF APPROPRIATIONS

<u>Description of Proposal</u>

The proposal authorizes to be appropriated to the Secretary of the Treasury $80 million for each fiscal year to carry out the administration of exempt organizations by the IRS.

The proposal authorizes to be appropriated to the Secretary of the Treasury $3 million to carry out the provisions of Public Laws 106-230 and 107-276, relating to section 527.

VII. REVENUE RAISING PROPOSALS

A. Provisions Designed to Curtail Tax Shelters

1. Clarification of the economic substance doctrine

<u>**Present Law**</u>

<u>**In general**</u>

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

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of tax motivated transactions, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. Although these doctrines serve an important role in the administration of the tax system, invocation of these doctrines can be seen as at odds with an objective, "rule-based" system of taxation. Nonetheless, courts have applied the doctrines to deny tax benefits arising from certain transactions.[115]

A common-law doctrine applied with increasing frequency is the "economic substance" doctrine. In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax.[116]

<u>Economic substance doctrine</u>

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

> The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction.

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

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

The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[117]

Business purpose doctrine

Another common law doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine. The business purpose test is a subjective inquiry into the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[118]

Application by the courts

Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine. Some courts apply a conjunctive test that requires a taxpayer to establish the presence of both economic substance (i.e., the objective component) and business purpose (i.e., the subjective component) in order for the transaction to sustain court scrutiny.[119] A narrower approach used by some courts is to invoke the economic substance doctrine only after a determination that the transaction lacks both a business purpose and economic substance (i.e., the existence of either a business purpose or economic substance would be sufficient to respect the transaction).[120] A third approach regards economic substance and business purpose as "simply

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

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

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

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

more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits.[121]

Profit potential

There also is a lack of uniformity regarding the necessity and level of profit potential necessary to establish economic substance. Since the time of *Gregory*, several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.[122] In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.[123] Under this analysis, the taxpayer's profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the tax benefits.[124] In these cases, in assessing whether a reasonable possibility of profit exists, it is sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits.

Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99) at 182.

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

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

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

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

Description of Proposal

In general

The proposal clarifies and enhances the application of the economic substance doctrine. The proposal provides that a transaction has economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.[125]

Conjunctive analysis

The proposal clarifies that the economic substance doctrine involves a conjunctive analysis -- there must be an objective inquiry regarding the effects of the transaction on the taxpayer's economic position, as well as a subjective inquiry regarding the taxpayer's motives for engaging in the transaction. Under the proposal, a transaction must satisfy both tests -- i.e., it must change in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and the taxpayer must have a substantial non-tax purpose for entering into such transaction (and the transaction is a reasonable means of accomplishing such purpose) -- in order to satisfy the economic substance doctrine. This clarification eliminates the disparity that exists among the circuits regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.

Non-tax business purpose

The proposal provides that a taxpayer's non-tax purpose for entering into a transaction (the second prong in the analysis) must be "substantial," and that the transaction must be "a reasonable means" of accomplishing such purpose. Under this formulation, the non-tax purpose for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities.[126]

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

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

In determining whether a taxpayer has a substantial non-tax business purpose, it is intended that an objective of achieving a favorable accounting treatment for financial reporting purposes will not be treated as having a substantial non-tax purpose.[127] Furthermore, a transaction that is expected to increase financial accounting income as a result of generating tax deductions or losses without a corresponding financial accounting charge (i.e., a permanent book-tax difference)[128] should not be considered to have a substantial non-tax purpose unless a substantial non-tax purpose exists apart from the financial accounting benefits.[129]

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

Profit potential

Under the proposal, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position; the proposal merely sets forth a minimum threshold of profit potential if that test is relied on to demonstrate a meaningful change in economic position. If a taxpayer relies on a profit potential, however, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.[130] Moreover, the profit potential must exceed a risk-free rate of

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

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

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

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

return. In addition, in determining pre-tax profit, fees and other transaction expenses and foreign taxes are treated as expenses.

In applying the profit test to the lessor of tangible property, certain deductions and other applicable tax credits (such as the rehabilitation tax credit and the low income housing tax credit) are not taken into account in measuring tax benefits. Thus, a traditional leveraged lease is not affected by the bill to the extent it meets the present law standards.

Transactions with tax-indifferent parties

The proposal also provides special rules for transactions with tax-indifferent parties. For this purpose, a tax-indifferent party means any person or entity not subject to Federal income tax, or any person to whom an item would have no substantial impact on its income tax liability. Under these rules, the form of a financing transaction will not be respected if the present value of the tax deductions to be claimed is substantially in excess of the present value of the anticipated economic returns to the lender. Also, the form of a transaction with a tax-indifferent party will not be respected if it results in an allocation of income or gain to the tax-indifferent party in excess of the tax-indifferent party's economic gain or income or if the transaction results in the shifting of basis on account of overstating the income or gain of the tax-indifferent party.

Other rules

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

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

Effective Date

The proposal applies to transactions entered into after the date of enactment.

2. Penalty for failure to disclose reportable transactions

Present Law

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[131]

[131] On October 17, 2002, Treasury Department and the IRS released new temporary and proposed regulations regarding the disclosure of reportable transactions. The regulations are effective for transactions entered into on or after January 1, 2003. Subsequent to the issuance of the new regulations, the IRS announced that, in light of the numerous comments received

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to)[132] a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction").[133]

The second category is any transaction that is offered under conditions of confidentiality. If a taxpayer's disclosure of the structure or tax aspects of the transaction is limited in any way by an express or implied understanding or agreement with or for the benefit of any person who makes or provides a statement, oral or written, as to the potential tax consequences that may result from the transaction, it is considered offered under conditions of confidentiality (whether or not the understanding is legally binding).[134]

The third category of reportable transaction is any transaction for which the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax consequences from the transaction will not be sustained. Such protection can include recission rights, the right to a refund of fees, contingent fees, insurance protection with respect to the tax treatment, or a tax indemnity or similar agreement.[135]

The fourth category of reportable transactions relates to any transaction resulting in, or that is reasonably expected to result in, a taxpayer claiming a loss (under section 165) of at least (1) $10 million in any single year or $20 million in any combination of years by a corporate taxpayer; (2) $5 million in any single year or $10 million in any combination of years by a partnership or S corporation; (3) $2 million in any single year or $4 million in any combination of years by an individual or trust; or (4) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.[136]

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regarding the new regulations, the revised regulations under section 6011 will permit taxpayers who entered into transactions on or after January 1, 2003 (and before the filing date of the revised regulations) to elect to apply the revised regulations. Notice 2003-11, 2003-6 I.R.B. 1 (January 17, 2003).

The discussion of present law refers to the new regulations. The rules that apply with respect to transactions entered into on or before December 31, 2002, are contained in Treas. Reg. sec. 1.6011-4T in effect prior to January 1, 2003.

[132] The regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. Also, the term must be broadly construed in favor of disclosureTemp. Treas. Reg. sec. 1-6011-4T(c)(4).

[133] Temp. Treas. Reg. sec. 1.6011-4T(b)(2).

[134] Temp. Treas. Reg. sec. 1.6011-4T(b)(3).

[135] Temp. Treas. Reg. sec. 1.6011-4T(b)(4).

[136] Temp. Treas. Reg. sec. 1.6011-4T(b)(5).

The fifth category of reportable transactions refers to any transaction done by certain taxpayers[137] in which the tax treatment of the transaction differs (or is expected to differ) by more than $10 million from its treatment for book purposes (using generally accepted accounting principles) in any year.[138]

The final category of reportable transactions is any transaction that results in a tax credit exceeding $250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.[139]

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure may jeopardize a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[140]

Description of Proposal

In general

The proposal creates a new penalty for any person who fails to include with any return or statement any required information with respect to a reportable transaction. The new penalty applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any accuracy-related penalty that may be imposed.

Transactions to be disclosed

The proposal does not define the terms "listed transaction"[141] or "reportable transaction," nor does the proposal explain the type of information that must be disclosed in order to avoid the

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[137] The significant book-tax category applies only to taxpayers that are reporting companies under the Securities Exchange Act of 1934 or business entities that have $100 million or more in gross assets.

[138] Temp. Treas. Reg. sec. 1.6011-4T(b)(6). The regulations exempt 13 types of transactions from the book-tax reportable transaction category. *See* Temp. Treas. Reg. sec. 1.6011-4T(b)(6)(iii)(A)-(M).

[139] Temp. Treas. Reg. sec. 1.6011-4T(b)(7).

[140] Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith. On December 31, 2002, the Treasury Department and IRS issued proposed regulations under sections 6662 and 6664 (REG-126016-01) that limit the defenses available to the imposition of an accuracy-related penalty in connection with a reportable transaction when the transaction is not disclosed.

[141] The proposal states that, except as provided in regulations, a listed transaction means a reportable transaction, which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section

imposition of a penalty. Rather, the proposal authorizes the Treasury Department to define a "listed transaction" and a "reportable transaction" under section 6011.

Penalty rate

The penalty for failing to disclose a reportable transaction is $50,000. The amount is increased to $100,000 if the failure is with respect to a listed transaction. For large entities and high net worth individuals, the penalty amount is doubled (i.e., $100,000 for a reportable transaction and $200,000 for a listed transaction). The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded or abated only if: (1) the taxpayer on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the IRS Commissioner personally or the head of the Office of Tax Shelter Analysis. Thus, the penalty cannot be rescinded by a revenue agent, an appeals officer, or any other IRS personnel. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no taxpayer right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this proposal and the reasons for the rescission.

A "large entity" is defined as any entity with gross receipts in excess of $10 million in the year of the transaction or in the preceding year. A "high net worth individual" is defined as any individual whose net worth exceeds $2 million, based on the fair market value of the individual's assets and liabilities immediately before entering into the transaction.

A public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an understatement penalty attributable to a non-disclosed listed transaction, a non-disclosed reportable avoidance transaction, or a transaction that lacks economic substance[142]) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission for such period as the Secretary shall specify. The proposal applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and treats any failure to disclose a transaction in such reports as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports

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6011. For this purpose, it is expected that the definition of "substantially similar" will be the definition used in Temp. Treas. Reg. sec. 1.6011-4T(b)(2). However, the Secretary may modify this definition (as well as the definitions of "listed transaction" and "reportable transactions") as appropriate.

[142] These categories of transactions are described in greater detail below in connection with the proposals modifying the accuracy-related penalty for listed and certain reportable transactions and a penalty for understatements attributable to transactions that lack economic substance.

to the Securities and Exchange Commission once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Effective Date

The proposal is effective for returns and statements the due date for which is after the date of enactment.

3. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose

Present Law

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[143] The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[144]

Special rules apply with respect to tax shelters.[145] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[146] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously

[143] Sec. 6662.

[144] Sec. 6662(d)(2)(B).

[145] Sec. 6662(d)(2)(C).

[146] Sec. 6664(c).

concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[147]

Description of Proposal

In general

The proposal modifies the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as a "reportable avoidance transaction").[148] The penalty rate and defenses available to avoid the penalty vary depending on the category of the transaction (i.e., listed or reportable avoidance transaction) and whether the transaction was adequately disclosed.

Disclosed transactions

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction. The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the "strengthened reasonable cause exception"), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

Undisclosed transactions

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a strict-liability penalty applies), and the taxpayer is subject to an increased penalty rate equal to 30 percent of the understatement.

In addition, a public entity that is required to pay the 30 percent penalty must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Once the 30 percent penalty has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner

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

[148] The terms "reportable transaction" and "listed transaction" have the same meanings as previously described in connection with the penalty for failing to disclose reportable transactions.

personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to submit an annual report to Congress summarizing the application of this penalty and providing a description of each penalty compromised under this proposal and the reasons for the compromise.

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this proposal, the amount of the understatement is determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return) [149], and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

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

Strengthened reasonable cause exception

A penalty is not imposed under the proposal with respect to any portion of an understatement if it shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011,[150] (2) there is or was substantial authority for such treatment, and (3) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

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

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

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

Disqualified tax advisor

A disqualified tax advisor is any advisor who (1) is a material advisor[151] and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267 or 707) to any person who so participates, (2) is compensated directly or indirectly[152] by a material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary, has a continuing financial interest with respect to the transaction.

Organization, management, promotion or sale of a transaction

A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body.[153] Participation in the "management" of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

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[151] The term "material advisor" (defined below in connection with the new information filing requirements for material advisors) means any person who provides any material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons ($250,000 in any other case).

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

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

Disqualified opinion

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

Coordination with other penalties

Any understatement to which a penalty is imposed under this proposal is not subject to the accuracy-related penalty under section 6662. However, such understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1).

The penalty imposed under this proposal shall not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

Effective Date

The proposal is effective for taxable years ending after the date of enactment.

4. Penalty for understatements from transactions lacking economic substance

Present Law

An accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[154] The amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

Special rules apply with respect to tax shelters.[155] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

[154] Sec. 6662.

[155] Sec. 6662(d)(2)(C).

The penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[156] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[157]

Description of Proposal

The proposal imposes a penalty for an understatement attributable to any transaction that lacks economic substance (referred to in the statute as a "non-economic substance transaction understatement").[158] The penalty rate is 40 percent (reduced to 20 percent if the taxpayer adequately discloses the relevant facts in accordance with regulations prescribed under section 6011). No exceptions (including the reasonable cause or rescission rules) to the penalty would be available under the proposal (i.e., the penalty is a strict-liability penalty).

A "non-economic substance transaction" means any transaction if (1) the transaction lacks economic substance (as defined in the earlier proposal regarding the economic substance doctrine),[159] (2) the transaction was not respected under the rules relating to transactions with tax-indifferent parties (as described in the earlier proposal regarding the economic substance doctrine),[160] or (3) any similar rule of law. For this purpose, a similar rule of law would include, for example, an understatement attributable to a transaction that is determined to be a sham transaction.

For purposes of this proposal, the calculation of an "understatement" is made in the same manner as in the separate proposal relating to accuracy-related penalties for listed and reportable avoidance transactions (new sec. 6662A). Thus, the amount of the understatement under this proposal would be determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other

[156] Sec. 6664(c).

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

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

[159] The proposal provides that a transaction has economic substance only if (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (2) the transaction has a substantial non-tax purpose for entering into such transaction and is a reasonable means of accomplishing such purpose.

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

items on the tax return),[161] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. In essence, the penalty will apply to the amount of any understatement attributable solely to a non-economic substance transaction.

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

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

Once a penalty (regardless of whether the transaction was disclosed) has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to submit an annual report to Congress summarizing the application of this penalty and providing a description of each penalty compromised under this proposal and the reasons for the compromise.

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

Effective Date

The proposal applies to transactions after the date of enactment.

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

5. Modifications to the substantial understatement penalty

Present Law

Definition of substantial understatement

An accuracy-related penalty equal to 20 percent applies to any substantial understatement of tax. A "substantial understatement" exists if the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations).[162]

Reduction of understatement for certain positions

For purposes of determining whether a substantial understatement penalty applies, the amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[163]

The Secretary is required to publish annually in the Federal Register a list of positions for which the Secretary believes there is not substantial authority and which affect a significant number of taxpayers.[164]

Description of Proposal

Definition of substantial understatement

The proposal modifies the definition of "substantial" for corporate taxpayers. Under the proposal, a corporate taxpayer has a substantial understatement if the amount of the understatement for the taxable year exceeds the lesser of (1) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000), or (2) $10 million.

Reduction of understatement for certain positions

The proposal elevates the standard that a taxpayer must satisfy in order to reduce the amount of an understatement for undisclosed items. With respect to the treatment of an item whose facts are not adequately disclosed, a resulting understatement is reduced only if the taxpayer had a reasonable belief that the tax treatment was more likely than not the proper treatment. The proposal also authorizes (but does not require) the Secretary to publish a list of positions for which it believes there is not substantial authority or there is no reasonable belief that the tax treatment is more likely than not the proper treatment (without regard to whether

[162] Sec. 6662(a) and (d)(1)(A).

[163] Sec. 6662(d)(2)(B).

[164] Sec. 6662(d)(2)(D).

such positions affect a significant number of taxpayers). The list shall be published in the Federal Register or the Internal Revenue Bulletin.

Effective Date

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

6. Tax shelter exception to confidentiality privileges relating to taxpayer communications

Present Law

In general, a common law privilege of confidentiality exists for communications between an attorney and client with respect to the legal advice the attorney gives the client. The Code provides that, with respect to tax advice, the same common law protections of confidentiality that apply to a communication between a taxpayer and an attorney also apply to a communication between a taxpayer and a federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. This rule is inapplicable to communications regarding corporate tax shelters.

Description of Proposal

The proposal modifies the rule relating to corporate tax shelters by making it applicable to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt entities, or any other entity. Accordingly, communications with respect to tax shelters are not subject to the confidentiality proposal of the Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.

Effective Date

The proposal is effective with respect to communications made on or after the date of enactment.

7. Disclosure of reportable transactions by material advisors

Present Law

Registration of tax shelter arrangements

An organizer of a tax shelter is required to register the shelter with the Secretary not later than the day on which the shelter is first offered for sale.[165] A "tax shelter" means any investment with respect to which the tax shelter ratio[166] for any investor as of the close of any of

[165] Sec. 6111(a).

[166] The tax shelter ratio is, with respect to any year, the ratio that the aggregate amount of the deductions and 350 percent of the credits, which are represented to be potentially allowable to any investor, bears to the investment base (money plus basis of assets contributed) as of the close of the tax year.

the first five years ending after the investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than $250,000 and at least five investors).[167]

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of Federal income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the promoter may receive fees in excess of $100,000 in the aggregate.[168]

A transaction has a "significant purpose of avoiding or evading Federal income tax" if the transaction: (1) is the same as or substantially similar to a "listed transaction,"[169] or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.[170] Certain exceptions are provided with respect to the second category of transactions.[171]

An arrangement is offered under conditions of confidentiality if: (1) an offeree has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows, or has reason to know that a party other than the potential participant claims that the transaction (or any aspect of it) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use.[172]

Failure to register tax shelter

The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of

[167] Sec. 6111(c).

[168] Sec. 6111(d).

[169] Temp. Treas. Reg. sec. 301.6111-2T(b)(2).

[170] Temp. Treas. Reg. sec. 301.6111-2T(b)(3).

[171] Temp. Treas. Reg. sec. 301.6111-2T(b)(4).

[172] The regulations provide that the determination of whether an arrangement is offered under conditions of confidentiality is based on all the facts and circumstances surrounding the offer. If an offeree's disclosure of the structure or tax aspects of the transaction are limited in any way by an express or implied understanding or agreement with or for the benefit of a tax shelter promoter, an offer is considered made under conditions of confidentiality, whether or not such understanding or agreement is legally binding. Treas. Reg. sec. 301.6111-2T(c)(1).

the aggregate amount invested in the shelter or $500.[173] However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

Section 6707 also imposes (1) a $100 penalty on the promoter for each failure to furnish the investor with the required tax shelter identification number, and (2) a $250 penalty on the investor for each failure to include the tax shelter identification number on a return.

Description of Proposal

Disclosure of reportable transactions by material advisors

The proposal repeals the present law rules with respect to registration of tax shelters. Instead, the proposal requires each material advisor with respect to any reportable transaction (including listed transaction)[174] to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe). The return must be filed on such date as specified by the Secretary.

The information return will include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. It is expected that the Secretary may seek from the material advisor the same type of information that the Secretary may request from a taxpayer in connection with a reportable transaction.[175]

A “material advisor” means any person (1) who provides material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of $250,000 ($50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons) for such advice or assistance.

The Secretary may prescribe regulations which provide (1) that only one material advisor has to file an information return in cases in which two or more material advisors would otherwise be required to file information returns with respect to a particular reportable transaction, (2) exemptions from the requirements of this section, and (3) other rules as may be necessary or appropriate to carry out the purposes of this section (including, for example, rules regarding the aggregation of fees in appropriate circumstances).

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[173] Sec. 6707.

[174] The terms “reportable transaction” and “listed transaction” have the same meaning as previously described in connection with the taxpayer-related proposals.

[175] *See* the previous discussion regarding the disclosure requirements under new section 6707A.

Penalty for failing to furnish information regarding reportable transactions

The proposal repeals the present law penalty for failure to register tax shelters. Instead, the proposal imposes a penalty on any material advisor who fails to file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).[176] The amount of the penalty is $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the gross income of such person with respect to aid, assistance, or advice which is provided with respect to the reportable transaction before the date the information return that includes the transaction is filed. Intentional disregard by a material advisor of the requirement to disclose a reportable transaction increases the penalty to 75 percent of the gross income.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded or abated only in exceptional circumstances.[177] All or part of the penalty may be rescinded only if: (1) the material advisor on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the Commissioner personally or the head of the Office of Tax Shelter Analysis; this authority to rescind cannot otherwise be delegated by the Commissioner. Thus, the penalty cannot be rescinded by a revenue agent, an appeals officer, or other IRS personnel. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this proposal and the reasons for the rescission.

Effective Date

The proposal requiring disclosure of reportable transactions by material advisors applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

The proposal imposing a penalty for failing to disclose reportable transactions applies to returns the due date for which is after the date of enactment.

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[176] The terms "reportable transaction" and "listed transaction" have the same meaning as previously described in connection with the taxpayer-related proposals.

[177] The Secretary's present-law authority to postpone certain tax-related deadlines because of Presidentially-declared disasters (sec. 7508A) will also encompass the authority to postpone the reporting deadlines established by the proposal.

8. Investor lists and modification of penalty for failure to maintain investor lists

Present Law

Investor lists

Any organizer or seller of a potentially abusive tax shelter must maintain a list identifying each person who was sold an interest in any such tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions).[178] Recently-issued temporary regulations under section 6112 contain elaborate rules regarding the list maintenance requirements.[179] The regulations apply to transactions that are potentially abusive tax shelters entered into, or acquired after, January 1, 2003.[180]

The temporary regulations, issued in October 2002, provide that a person is an organizer or seller of a potentially abusive tax shelter if the person is a material advisor with respect to that transaction.[181] A potentially abusive tax shelter is any transaction that (1) is required to be registered under section 6111, (2) is a listed transaction (as defined under the new temporary regulations under section 6011), or (3) any transaction that a potential material advisor knows or has reason to know, at the time the transaction is entered into, is a reportable transaction (as defined under the new temporary regulations under section 6011).[182]

The temporary regulations define an organizer or a seller of an interest with respect to a potentially abusive tax shelter if that person is a "material advisor." A material advisor is defined any person who (directly or indirectly) receives, or is expected to receive, a minimum fee of (1) $250,000 for a transaction that is a potentially abusive tax shelter if all participants are corporations, or (2) $50,000 for any other transaction that is a potentially abusive tax shelter.[183]

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[178] Sec. 6112.

[179] Temp. Treas. Reg. sec. 301-6112-1T.

[180] Subsequent to the issuance of the new regulations, the IRS announced that, in order to provide necessary clarification of the list maintenance regulations, the effective date will be changed to the date that revised regulations under section 6112 are filed. The delayed effective date, however, will not apply to listed transactions or transactions that are section 6111 shelters (as defined in Treas. Reg. sec. 301.6112-1T(b)(1)). Notice 2003-11, 2003-6 I.R.B. 1 (January 17, 2003).

[181] Temp. Treas. Reg. sec. 301.6112-1T(c)(1).

[182] Temp. Treas. Reg. sec. 301.6112-1T(b).

[183] Temp. Treas. Reg. sec. 301.6112-1T(c)(1) and (2).

The Secretary is required to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.[184]

Penalties for failing to maintain investor lists

Under section 6708, the penalty for failing to maintain the list required under section 6112 is $50 for each name omitted from the list (with a maximum penalty of $100,000 per year).

Description of Proposal

Investor lists

Each material advisor[185] that is required to file an information return with respect to a reportable transaction (including a listed transaction)[186] is required to maintain a list that (1) identifies each person with respect to whom the advisor acted as a material advisor with respect to the reportable transaction, and (2) contains other information as may be required by the Secretary. In addition, the proposal authorizes (but does not require) the Secretary to prescribe regulations which provide that, in cases in which 2 or more persons are required to maintain the same list, only one person would be required to maintain the list.

Penalty for failing to maintain investor lists

The proposal modifies the penalty for failing to maintain the required list by making it a time-sensitive penalty. Thus, a material advisor who is required to maintain an investor list and who fails to make the list available upon request by the Secretary within 20 business days after the request will be subject to a $10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but does not make the list available to the Secretary. The penalty can be waived if the failure to make the list available is due to reasonable cause.[187]

Effective Date

The proposal requiring a material advisor to maintain an investor list applies to transactions with respect to which material aid, assistance or advice is provided after the date of enactment.

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[184] Sec. 6112(c)(2).

[185] The term "material advisor" has the same meaning as when used in connection with the requirement to file an information return under section 6111.

[186] The terms "reportable transaction" and "listed transaction" have the same meaning as previously described in connection with the taxpayer-related proposals.

[187] In no event will failure to maintain a list be considered reasonable cause for failing to make a list available to the Secretary.

The proposal imposing a penalty for failing to maintain investor lists applies to requests made after the date of enactment.

9. Actions to enjoin conduct with respect to tax shelters and reportable transactions

Present Law

The Code authorizes civil action to enjoin any person from promoting abusive tax shelters or aiding or abetting the understatement of tax liability.[188]

Description of Proposal

The proposal expands this rule so that injunctions may also be sought with respect to the requirements relating to the reporting of reportable transactions[189] and the keeping of lists of investors by material advisors.[190] Thus, under the proposal, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Secretary, a list of investors with respect to each reportable transaction.

Effective Date

The proposal is effective on the day after the date of enactment.

10. Understatement of taxpayer's liability by income tax return preparer

Present Law

An income tax return preparer who prepares a return with respect to which there is an understatement of tax that is due to a position for which there was not a realistic possibility of being sustained on its merits and the position was not disclosed (or was frivolous) is liable for a penalty of $250, provided that the preparer knew or reasonably should have known of the position. An income tax return preparer who prepares a return and engages in specified willful or reckless conduct with respect to preparing such a return is liable for a penalty of $1,000.

Description of Proposal

The proposal alters the standards of conduct that must be met to avoid imposition of the first penalty. The proposal replaces the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The proposal also replaces the not frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position.

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[188] Sec. 7408.

[189] Sec. 6707, as amended by other proposals of this bill.

[190] Sec. 6708, as amended by other proposals of this bill.

In addition, the proposal increases the amount of these penalties. The penalty relating to not having a reasonable belief that the tax treatment was more likely than not the proper tax treatment is increased from $250 to $1,000. The penalty relating to willful or reckless conduct is increased from $1,000 to $5,000.

Effective Date

The proposal is effective for documents prepared after the date of enactment.

11. Penalty for failure to report interests in foreign financial accounts

Present Law

The Secretary of the Treasury must require citizens, residents, or persons doing business in the United States to keep records and file reports when that person makes a transaction or maintains an account with a foreign financial entity.[191] In general, individuals must fulfill this requirement by answering questions regarding foreign accounts or foreign trusts that are contained in Part III of Schedule B of the IRS Form 1040. Taxpayers who answer "yes" in response to the question regarding foreign accounts must then file Treasury Department Form TD F 90-22.1. This form must be filed with the Department of the Treasury, and not as part of the tax return that is filed with the IRS.

The Secretary of the Treasury may impose a civil penalty on any person who willfully violates this reporting requirement. The civil penalty is the amount of the transaction or the value of the account, up to a maximum of $100,000; the minimum amount of the penalty is $25,000.[192] In addition, any person who willfully violates this reporting requirement is subject to a criminal penalty. The criminal penalty is a fine of not more than $250,000 or imprisonment for not more than five years (or both); if the violation is part of a pattern of illegal activity, the maximum amount of the fine is increased to $500,000 and the maximum length of imprisonment is increased to 10 years.[193]

On April 26, 2002, the Secretary of the Treasury submitted to the Congress a report on these reporting requirements.[194] This report, which was statutorily required,[195] studies methods for improving compliance with these reporting requirements. It makes several administrative

[191] 31 U.S.C. 5314.

[192] 31 U.S.C. 5321(a)(5).

[193] 31 U.S.C. 5322.

[194] *A Report to Congress in Accordance with Sec. 361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001*, April 26, 2002.

[195] Sec. 361(b) of the USA PATRIOT Act of 2001 (Pub. L. 107-56).

recommendations, but no legislative recommendations. A further report was required to be submitted by the Secretary of the Treasury to the Congress by October 26, 2002.

Description of Proposal

The proposal adds an additional civil penalty that may be imposed on any person who violates this reporting requirement (without regard to willfulness). This new civil penalty is up to $5,000. The penalty may be waived if any income from the account was properly reported on the income tax return and there was reasonable cause for the failure to report.

Effective Date

The proposal is effective with respect to failures to report occurring on or after the date of enactment.

12. Frivolous tax returns and submissions

Present Law

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of $500 imposed by the IRS (sec. 6702). The Code also permits the Tax Court[196] to impose a penalty of up to $25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

Description of Proposal

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

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

The proposal requires the IRS to publish a list of positions, arguments, requests, and proposals determined to be frivolous for purposes of these proposals.

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

Effective Date

The proposal is effective for submissions made and issues raised after the date on which the Secretary first prescribes the required list.

13. Regulation of individuals practicing before the Department of the Treasury

Present Law

The Secretary of the Treasury is authorized to regulate the practice of representatives of persons before the Department of the Treasury.[197] The Secretary is also authorized to suspend or disbar from practice before the Department a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented). The rules promulgated by the Secretary pursuant to this proposal are contained in Circular 230.

Description of Proposal

The proposal makes two modifications to expand the sanctions that the Secretary may impose pursuant to these statutory proposals. First, the proposal expressly permits censure as a sanction. Second, the proposal permits the imposition of a monetary penalty as a sanction. If the representative is acting on behalf of an employer or other entity, the Secretary may impose a monetary penalty on the employer or other entity if it knew, or reasonably should have known, of the conduct. This monetary penalty on the employer or other entity may be imposed in addition to any monetary penalty imposed directly on the representative. These monetary penalties are not to exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. These monetary penalties may be in addition to, or in lieu of, any suspension, disbarment, or censure.

The proposal also confirms the present-law authority of the Secretary to impose standards applicable to written advice with respect to an entity, plan, or arrangement that is of a type that the Secretary determines as having a potential for tax avoidance or evasion.

Effective Date

The modifications to expand the sanctions that the Secretary may impose are effective for actions taken after the date of enactment.

14. Penalties on promoters of tax shelters

Present Law

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or

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[197] 31 U.S.C. 330.

arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.[198] A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

The amount of the penalty is $1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

Description of Proposal

The proposal modifies the penalty amount to equal 50 percent of the gross income derived by the person from the activity for which the penalty is imposed. The new penalty rate applies to any activity that involves a statement regarding the tax benefits of participating in a plan or arrangement if the person knows or has reason to know that such statement is false or fraudulent as to any material matter. The enhanced penalty does not apply to a gross valuation overstatement.

Effective Date

The proposal is effective for activities after the date of enactment.

15. Extend statute of limitations for certain undisclosed transactions

Present Law

In general, the Code requires that taxes be assessed within three years[199] after the date a return is filed.[200] If there has been a substantial omission of items of gross income that total more than 25 percent of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years.[201] If an assessment is not made within the required time periods, the tax generally cannot be assessed or collected at any future

[198] Sec. 6700.

[199] Sec. 6501(a).

[200] For this purpose, a return that is filed before the date on which it is due is considered to be filed on the required due date (sec. 6501(b)(1)).

[201] Sec. 6501(e).

time. Tax may be assessed at any time if the taxpayer files a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all.[202]

Description of Proposal

The proposal extends the statute of limitations to six years with respect to the entire tax return[203] if a taxpayer required to disclose a listed transaction[204] fails to do so in the manner required. For example, if a taxpayer entered into a transaction in 2001 that becomes a listed transaction in 2002 and the taxpayer fails to disclose such transaction in the manner required by Treasury regulations, the 2001 tax return will be subject to a six-year statute of limitations.[205]

Effective Date

The proposal is effective for transactions entered into in taxable years beginning after the date of enactment.

16. Deny deduction for interest paid to IRS on underpayments involving certain tax-motivated transactions

Present Law

In general, corporations may deduct interest paid or accrued within a taxable year on indebtedness.[206] Interest on indebtedness to the Federal government attributable to an underpayment of tax generally may be deducted pursuant to this provision.

Description of Proposal

The proposal disallows any deduction for interest paid or accrued within a taxable year on any portion of an underpayment of tax that is attributable to an understatement arising from

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[202] Sec. 6501(c).

[203] The tax year extended is the tax year the transaction is entered into.

[204] The term "listed transaction" has the same meaning as described in a previous proposal regarding the penalty for failure to disclose reportable transactions.

[205] However, if the Treasury Department lists a transaction in a year subsequent to the year a taxpayer entered into such transaction, and the taxpayer's tax return for the year the transaction was entered into is closed by the statute of limitations prior to the transaction becoming a listed transaction, this proposal does not re-open the statute of limitations for such year.

[206] Sec. 163(a).

(1) an undisclosed reportable avoidance transaction, (2) an undisclosed listed transaction, or (3) a transaction that lacks economic substance.[207]

Effective Date

The proposal is effective for underpayments attributable to transactions entered into in taxable years beginning after the date of enactment.

17. Authorize additional $300 million per year to the IRS to combat abusive tax avoidance transactions

The proposal includes an authorization of an additional $300 million to the Internal Revenue Service to be used to combat abusive tax avoidance transactions.

[207] The definitions of these transactions are the same as those previously described in connection with the proposal to modify the accuracy-related penalty for listed and certain reportable transactions and the proposal to impose a penalty on understatements attributable to transactions that lack economic substance.

B. Other Provisions

1. Affirmation of consolidated return regulation authority

Present Law

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns. A condition of electing to file a consolidated return is that all corporations that are members of the consolidated group must consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for filing such return.[208]

Section 1502 states:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability.[209]

Under this authority, the Treasury Department has issued extensive consolidated return regulations.[210]

In the recent case of *Rite Aid Corp. v. United States*,[211] the Federal Circuit Court of Appeals addressed the application of a particular provision of certain consolidated return loss

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208 Sec. 1501.

209 Sec. 1502.

210 Regulations issued under the authority of section 1502 are considered to be "legislative" regulations rather than "interpretative" regulations, and as such are usually given greater deference by courts in case of a taxpayer challenge to such a regulation. *See*, S. Rep. No. 960, 70th Cong., 1st Sess. at 15, describing the consolidated return regulations as "legislative in character". The Supreme Court has stated that ". . . legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984) (involving an environmental protection regulation). For examples involving consolidated return regulations, *see, e.g., Wolter Construction Company v. Commissioner*, 634 F.2d 1029 (6th Cir. 1980); *Garvey, Inc. v.United States*, 1 Ct. Cl. 108 (1983), *aff'd* 726 F.2d 1569 (Fed. Cir. 1984), *cert. denied* 469 U.S. 823 (1984). *Compare, e.g., Audrey J. Walton v. Commissioner*, 115 T.C. 589 (2000), describing different standards of review. The case did not involve a consolidated return regulation.

211 255 F.3d 1357 (Fed. Cir. 2001), *reh'g denied*, 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001).

disallowance regulations, and concluded that the provision was invalid.[212] The particular provision, known as the "duplicated loss" provision,[213] would have denied a loss on the sale of stock of a subsidiary by a parent corporation that had filed a consolidated return with the subsidiary, to the extent the subsidiary corporation had assets that had a built-in loss, or had a net operating loss, that could be recognized or used later.[214]

[212] Prior to this decision, there had been a few instances involving prior laws in which certain consolidated return regulations were held to be invalid. *See, e.g., American Standard, Inc. v. United States,* 602 F.2d 256 (Ct. Cl. 1979), discussed in the text *infra. see also Union Carbide Corp. v. United States,* 612 F.2d 558 (Ct. Cl. 1979), and *Allied Corporation v. United States,* 685 F. 2d 396 (Ct. Cl. 1982), all three cases involving the allocation of income and loss within a consolidated group for purposes of computation of a deduction allowed under prior law by the Code for Western Hemisphere Trading Corporations. *See also Joseph Weidenhoff v. Commissioner*, 32 T.C. 1222, 1242-1244 (1959), involving the application of certain regulations to the excess profits tax credit allowed under prior law, and concluding that the Commissioner had applied a particular regulation in an arbitrary manner inconsistent with the wording of the regulation and inconsistent with even a consolidated group computation. *Cf. Kanawha Gas & Utilities Co. v. Commissioner*, 214 F.2d 685 (1954), concluding that the substance of a transaction was an acquisition of assets rather than stock. Thus, a regulation governing basis of the assets of consolidated subsidiaries did not apply to the case. *See also General Machinery Corporation v. Commissioner*, 33 B.T.A. 1215 (1936); *Lefcourt Realty Corporation,* 31 B.T.A. 978 (1935); *Helvering v. Morgans, Inc*., 293 U.S. 121 (1934), interpreting the term "taxable year."

[213] Treas. Reg. Sec. 1.1502-20(c)(1)(iii).

[214] Treasury Regulation section 1.1502-20, generally imposing certain "loss disallowance" rules on the disposition of subsidiary stock, contained other limitations besides the "duplicated loss" rule that could limit the loss available to the group on a disposition of a subsidiary's stock. Treasury Regulation section 1.1502-20 as a whole was promulgated in connection with regulations issued under section 337(d), principally in connection with the so-called *General Utilities* repeal of 1986 (referring to the case of *General Utilities & Operating Company v. Helvering*, 296 U.S. 200 (1935)). Such repeal generally required a liquidating corporation, or a corporation acquired in a stock acquisition treated as a sale of assets, to pay corporate level tax on the excess of the value of its assets over the basis. Treasury regulation section 1.1502-20 principally reflected an attempt to prevent corporations filing consolidated returns from offsetting income with a loss on the sale of subsidiary stock. Such a loss could result from the unique upward adjustment of a subsidiary's stock basis required under the consolidated return regulations for subsidiary income earned in consolidation, an adjustment intended to prevent taxation of both the subsidiary and the parent on the same income or gain. As one example, absent a denial of certain losses on a sale of subsidiary stock, a consolidated group could obtain a loss deduction with respect to subsidiary stock, the basis of which originally reflected the subsidiary's value at the time of the purchase of the stock, and that had then been adjusted upward on recognition of any built-in income or gain of the subsidiary reflected in that value. The regulations also contained the duplicated loss factor addressed by the court in *Rite Aid*. The preamble to the regulations stated: "it is not administratively feasible to differentiate

The Federal Circuit Court opinion contained language discussing the fact that the regulation produced a result different than the result that would have obtained if the corporations had filed separate returns rather than consolidated returns.[215]

The Federal Circuit Court opinion cited a 1928 Senate Finance Committee Report to legislation that authorized consolidated return regulations, which stated that "many difficult and complicated problems, ... have arisen in the administration of the provisions permitting the filing of consolidated returns" and that the committee "found it necessary to delegate power to the commissioner to prescribe regulations legislative in character covering them."[216] The Court's opinion also cited a previous decision of the Court of Claims for the proposition, interpreting this legislative history, that section 1502 grants the Secretary "the power to conform the applicable income tax law of the Code to the special, myriad problems resulting from the filing of consolidated income tax returns;" but that section 1502 "does not authorize the Secretary to choose a method that imposes a tax on income that would not otherwise be taxed." [217]

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between loss attributable to built-in gain and duplicated loss." T.D. 8364, 1991-2 C.B. 43, 46 (Sept. 13, 1991). The government also argued in the *Rite Aid* case that duplicated loss was a separate concern of the regulations. 255 F.3d at 1360.

[215] For example, the court stated: "The duplicated loss factor . . . addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165." 255 F.3d 1357, 1360 (Fed. Cir. 2001).

[216] S. Rep. No. 960, 70th Cong., 1st Sess. 15 (1928). Though not quoted by the court in *Rite Aid*, the same Senate report also indicated that one purpose of the consolidated return authority was to permit treatment of the separate corporations as if they were a single unit, stating "The mere fact that by legal fiction several corporations owned by the same shareholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit." S. Rep. No. 960, 70th Cong., 1st Sess. 29 (1928).

[217] *American Standard, Inc. v. United States*, 602 F.2d 256, 261 (Ct. Cl. 1979). That case did not involve the question of separate returns as compared to a single return approach. It involved the computation of a Western Hemisphere Trade Corporation ("WHTC") deduction under prior law (which deduction would have been computed as a percentage of each WHTC's taxable income if the corporations had filed separate returns), in a case where a consolidated group included several WHTCs as well as other corporations. The question was how to apportion income and losses of the admittedly consolidated WHTCs and how to combine that computation with the rest of the group's consolidated income or losses. The court noted that the new, changed regulations approach varied from the approach taken to a similar problem involving public utilities within a group and previously allowed for WHTCs. The court objected that the allocation method adopted by the regulation allowed non-WHTC losses to reduce WHTC income. However, the court did not disallow a method that would net WHTC income of one WHTC with losses of another WHTC, a result that would not have occurred under separate

The Federal Circuit Court construed these authorities and applied them to invalidate Treas. Reg. Sec. 1.1502-20(c)(1)(iii), stating that:

> The loss realized on the sale of a former subsidiary's assets after the consolidated group sells the subsidiary's stock is not a problem resulting from the filing of consolidated income tax returns. The scenario also arises where a corporate shareholder sells the stock of a non-consolidated subsidiary. The corporate shareholder could realize a loss under I.R.C. sec. 1001, and deduct the loss under I.R.C. sec. 165. The subsidiary could then deduct any losses from a later sale of assets. The duplicated loss factor, therefore, addresses a situation that arises from the sale of stock regardless of whether corporations file separate or consolidated returns. With I.R.C. secs. 382 and 383, Congress has addressed this situation by limiting the subsidiary's potential future deduction, not the parent's loss on the sale of stock under I.R.C. sec. 165.[218]

The Treasury Department has announced that it will not continue to litigate the validity of the duplicated loss provision of the regulations, and has issued interim regulations that permit taxpayers for all years to elect a different treatment, though they may apply the provision for the past if they wish.[219]

Description of Proposal

The proposal confirms that, in exercising its authority under section 1502 to issue consolidated return regulations, the Treasury Department may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

Thus, under the statutory authority of section 1502, the Treasury Department is authorized to issue consolidated return regulations utilizing either a single taxpayer or separate taxpayer approach or a combination of the two approaches, as Treasury deems necessary in order that the tax liability of any affiliated group of corporations making a consolidated return, and of each corporation in the group, both during and after the period of affiliation, may be determined

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returns. Nor did the court expressly disallow a different fractional method that would net both income and losses of the WHTCs with those of other corporations in the consolidated group. The court also found that the regulation had been adopted without proper notice.

[218] *Rite Aid*, 255 F.3d at 1360.

[219] *See* Temp. Reg. 1.1502-20T(i)(2). The Treasury Department has also indicated its intention to continue to study all the issues that the original loss disallowance regulations addressed (including issues of furthering single entity principles) and possibly issue different regulations (not including the particular approach of Treas. Reg. Sec. 1.1502-20(c)(1)(iii)) on the issues in the future. *See* Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (March 12, 2002); REG-102740-02, 67 F.R. 11070 (March 12, 2002); *see also* Notice 2002-18, 2002-12 I.R.B. 644 (March 25, 2002).

and adjusted in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such liability.

Rite Aid is thus overruled to the extent it suggests that there is not a problem that can be addressed in consolidated return regulations if application of a particular Code provision on a separate taxpayer basis would produce a result different from single taxpayer principles that may be used for consolidation.

The proposal nevertheless allows the result of the *Rite Aid* case to stand with respect to the type of factual situation presented in the case. That is, the legislation provides for the override of the regulatory provision that took the approach of denying a loss on a deconsolidating disposition of stock of a consolidated subsidiary[220] to the extent the subsidiary had net operating losses or built in losses that could be used later outside the group.[221]

Retaining the result in the *Rite Aid* case with respect to the particular regulation section 1.1502-20(c)(1)(iii) as applied to the factual situation of the case does not in any way prevent or invalidate the various approaches Treasury has announced it will apply or that it intends to consider in lieu of the approach of that regulation, including, for example, the denial of a loss on a stock sale if inside losses of a subsidiary may also be used by the consolidated group, and the possible requirement that inside attributes be adjusted when a subsidiary leaves a group.[222]

Effective Date

The proposal is effective for all years, whether beginning before, on, or after the date of enactment of the proposal.

No inference is intended that the results following from this proposal are not the same as the results under present law.

[220] Treas. Reg. Sec. 1.1502-20(c)(1)(iii).

[221] The proposal is not intended to overrule the current Treasury Department regulations, which allow taxpayers for the past to follow Treasury Regulations Section 1.1502-20(c)(1)(iii), if they choose to do so. Temp. Reg. Sec. 1.1502-20T(i)(2).

[222] *See, e.g.*, Notice 2002-11, 2002-7 I.R.B. 526 (Feb. 19, 2002); T.D. 8984, 67 F.R. 11034 (Mar.12, 2002); REG-102740-02, 67 F.R. 11070 (Mar.12, 2002); *see also* Notice 2002-18, 2002-12 I.R.B. 644 (Mar. 25, 2002). In exercising its authority under section 1502, the Secretary is also authorized to prescribe rules that protect the purpose of *General Utilities* repeal using presumptions and other simplifying conventions.