

108TH CONGRESS }
2nd Session

COMMITTEE PRINT

{ WMCP:
108-10

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

WRITTEN COMMENTS

ON

**H.R. 3654, THE “TECHNICAL
CORRECTIONS ACT OF 2003”**



JANUARY 23, 2004

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE

91-964 DTP

WASHINGTON : 2004

COMMITTEE ON WAYS AND MEANS

BILL THOMAS, California, *Chairman*

PHILIP M. CRANE, Illinois	CHARLES B. RANGEL, New York
E. CLAY SHAW, JR., Florida	FORTNEY PETE STARK, California
NANCY L. JOHNSON, Connecticut	ROBERT T. MATSUI, California
AMO HOUGHTON, New York	SANDER M. LEVIN, Michigan
WALLY HERGER, California	BENJAMIN L. CARDIN, Maryland
JIM MCCRERY, Louisiana	JIM MCDERMOTT, Washington
DAVE CAMP, Michigan	GERALD D. KLECZKA, Wisconsin
JIM RAMSTAD, Minnesota	JOHN LEWIS, Georgia
JIM NUSSLE, Iowa	RICHARD E. NEAL, Massachusetts
SAM JOHNSON, Texas	MICHAEL R. MCNULTY, New York
JENNIFER DUNN, Washington	WILLIAM J. JEFFERSON, Louisiana
MAC COLLINS, Georgia	JOHN S. TANNER, Tennessee
ROB PORTMAN, Ohio	XAVIER BECERRA, California
PHIL ENGLISH, Pennsylvania	LLOYD DOGGETT, Texas
J.D. HAYWORTH, Arizona	EARL POMEROY, North Dakota
JERRY WELLER, Illinois	MAX SANDLIN, Texas
KENNY C. HULSHOF, Missouri	STEPHANIE TUBBS JONES, Ohio
SCOTT MCINNIS, Colorado	
RON LEWIS, Kentucky	
MARK FOLEY, Florida	
KEVIN BRADY, Texas	
PAUL RYAN, Wisconsin	
ERIC CANTOR, Virginia	

Allison H. Giles, *Chief of Staff*

Janice Mays, *Minority Chief Counsel*

Pursuant to clause 2(e)(4) of Rule XI of the Rules of the House, public hearing records of the Committee on Ways and Means are also published in electronic form. **The printed hearing record remains the official version.** Because electronic submissions are used to prepare both printed and electronic versions of the hearing record, the process of converting between various electronic formats may introduce unintentional errors or omissions. Such occurrences are inherent in the current publication process and should diminish as the process is further refined.

CONTENTS

	Page
Advisory of Tuesday, December 9, 2003, announcing request for written comments on H.R. 3654, the “Technical Corrections Act of 2003”	1
BDO Seidman, LLP, National Tax Office, Donald A. Barnes, letter	2
Burlington Northern Santa Fe Corporation, Fort Worth, TX, Thomas N. Hund, letter	4
Iacopi, Lenz & Company Accountancy Corporation, Stockton, CA, Constance Logan, statement	5
Investment Company Institute, statement and attachment	11
Jackson & Campbell, PC, Michael J. Grace, letter	14
National Association of Real Estate Investment Trusts, Tony M. Edwards, letter	17
Perkins & Company, PC, Portland, OR, Christopher J. Loughran, letter	18
Vinson & Elkins, LLP, Christine L. Vaughn, and Thomas Crichton, IV, letter	20
Vitter, Hon. David, a Representative in Congress from the State of Louisiana, letter	23

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
December 9, 2003
No. FC-10

CONTACT: (202) 225-1721

Thomas Announces Request for Written Comments on H.R. 3654, the “Technical Corrections Act of 2003”

Congressman Bill Thomas (R-CA), Chairman of the Committee on Ways and Means, today announced that the Committee is requesting written public comments for the record from all parties interested in H.R. 3654, the “Technical Corrections Act of 2003.”

BACKGROUND:

Yesterday, Chairman Bill Thomas, along with Ranking Member Charles Rangel (D-NY), introduced H.R. 3654, the “Technical Corrections Act of 2003.”

H.R. 3654 includes provisions that technically correct and clarify the intent of previous tax laws.

“We hope the public will review the proposed changes and provide comments during the coming months so we can send appropriate legislation to the President as soon as possible,” said Thomas.

The bill includes technical corrections to the provisions relating to dividends taxed at capital gains rates that were enacted in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-26). The bill also includes technical corrections to the rules relating to bonus depreciation, carryback of net operating losses and other provisions that were enacted in the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147).

Technical corrections and clerical amendments to other enacted tax legislation, including the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), the Victims of Terrorism Tax Relief Act of 2001 (P.L. 107-134), the Community Renewal Act of 2000 (P.L. 106-554), the Taxpayer Relief Act of 1997 (P.L. 105-34) and the Small Business Job Protection Act of 1996 (P.L. 104-188) are also included in the bill.

Senate Finance Chairman Charles Grassley (R-IA) and Ranking Member Max Baucus (D-MT) have introduced companion legislation in the Senate.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit written comments for the record should send it electronically to hearingclerks.waysandmeans@mail.house.gov, along with a fax copy to (202) 225-2610, by close of business Friday, January 23, 2004. Please note that in the immediate future, the Committee website will allow for elec-

tronic submissions to be included in the printed record. Before submitting your comments, check to see if this function is available. **Finally**, due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. Due to the change in House mail policy, all statements and any accompanying exhibits for printing must be submitted electronically to hearingclerks.waysandmeans@mail.house.gov, along with a fax copy to (202) 225-2610, in Word Perfect or MS Word format and **MUST NOT** exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Any statements must include a list of all clients, persons, or organizations on whose behalf the witness appears. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at <http://waysandmeans.house.gov>.

BDO Seidman, LLP, National Tax Office
Washington, DC 20036
January 23, 2004

Chairman William M. Thomas
House Ways and Means Committee
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Thomas,

In response to your request for comments regarding additional technical corrections that may be needed to the Job Creation and Worker Assistance Act of 2002, we respectfully submit the following comments. We ask that the taxwriting Committees consider a minor addition to section 3(b) of the Tax Technical Corrections Act of 2003 to rectify the problem described below.

I. Applicable Statutory Provisions

IRC § 172(b)(1)(H) provides that “[i]n the case of a taxpayer which has a net operating loss for any taxable year ending during 2001 or 2002, subparagraph (A)(i) shall be applied by substituting ‘5’ for ‘2’ and subparagraph (F) shall not apply.”

IRC § 172(b)(3) provides that “[a]ny taxpayer entitled to a carryback period under paragraph (1) may elect to relinquish the entire carryback period with respect to a net operating loss for any taxable year.”

IRC § 172(j) provides that “[a]ny taxpayer entitled to a 5-year carryback under subsection (b)(1)(H) from any loss year may elect to have the carryback period with respect to such loss year determined without regard to subsection (b)(1)(H).”

II. Problem

The 2002 tax legislation was enacted in March 2002, after some taxpayers had filed their tax returns for 2001. In May 2002, the Internal Revenue Service issued Rev. Proc. 2002-40, 2002-1 C.B. 1096, the purpose of which was to provide administrative relief for taxpayers that filed tax returns for 2001 or 2002 without taking advantage of the new 5-year NOL carryback period provided by IRC § 172(b)(1)(H). The administrative guidance provided by Rev. Proc. 2002-40 is applicable whether the taxpayer filed its 2001 or 2002 tax returns before or after enactment of the 2002 tax legislation.

Section 5 of Rev. Proc. 2002-40 addressed taxpayers that previously filed a NOL carryback claim from tax years ending in 2001 or 2002 using a 2-year carryback period. Section 5 is subdivided in two parts—§ 5.01 is directed to those taxpayers that filed a 2-year carryback claim but want to use a 5-year carryback period, and § 5.02 is directed to those taxpayers that filed a 2-year carryback claim and want to use a 2-year carryback period.

The factual situation we are concerned about involves corporate taxpayers that had net operating losses in their taxable years ending during 2001, did not make an election under IRC § 172(b)(3), filed a 2-year carryback claim before enactment of the 2002 tax legislation, want to use a 5-year carryback period, but did not file a carryback claim using a 5-year period by October 31, 2002 as required by Rev. Proc. 2002-40, § 5.01. Some taxpayers in this category had significant financial or operational problems and were unable to obtain professional tax advice regarding the somewhat unusual filing requirement imposed by Rev. Proc. 2002-40, § 5.01.

For the reasons discussed below, we think these taxpayers should be provided relief in the Technical Corrections Act.

III. Reasons Why Relief Should Be Provided in the Tax Technical Corrections Act of 2003

For several reasons, we believe taxpayers that filed their 2001 tax returns prior to enactment of the 2002 tax legislation should be entitled to a 5-year carryback of those NOLs even if they did not meet the filing requirement imposed by Rev. Proc. 2002-40, § 5.01, and that the carryback should be available as long as the statute of limitations is open for the year in which the NOL was incurred.

A. Rev. Proc. 2002-40, § 5.01 imposes an extra-statutory requirement.

The Job Creation and Worker Assistance Act of 2002 permits taxpayers to carry back NOLs incurred in taxable years ending during 2001 or 2002 5 years and does not address the situation of taxpayers that had filed tax returns and carryback claims for 2001 or 2002 prior to enactment of the statute.

In pertinent part, Rev. Proc. 2002-40, § 5.01 reads as follows:

“If a taxpayer that previously filed an application for a tentative carryback adjustment (whether or not the Service has acted upon such application) or an amended return using a 2-year carryback period for an NOL incurred in a taxable year ending in 2001 or 2002, and that did not elect to forgo the 5-year carryback period under 172(j), wants to use the 5-year carryback period provided under 172(b)(1)(H), the taxpayer may do so by following the procedures of section 7 of this revenue procedure on or before October 31, 2002.”

Rev. Proc. 2002-40, § 7.01 requires a corporate taxpayer to file a Form 1139 or Form 1120X using a 5-year carryback period by October 31, 2002.

The general rule in IRC § 172 is that taxpayers *must* carry back NOLs 5 years, unless they elect not to carry back the NOL at all, or elect to forego the 5-year carryback period in favor of the 2-year carryback period. Thus, the general rule is that taxpayers are entitled to a 5-year carryback of NOLs incurred in tax years ending in 2001 or 2002 if they do nothing and make no elections. Rev. Proc. 2002-40, § 5.01 reverses this statutory presumption and imposes an affirmative election and filing obligation on taxpayers that want to carry back their NOLs 5 years.

Furthermore, the October 31, 2002 filing deadline imposed by Rev. Proc. 2002-40, § 5.01 has no basis in the statute. We understand the October 31, 2002 deadline was an arbitrary date selected by the Service to provide taxpayers with *additional* time to revoke an IRC § 172(b)(3) election, to make an IRC § 172(j) election, or to file a Form 1139. While providing taxpayers additional time to meet these statutory deadlines is appropriate, it is not appropriate to impose an arbitrary deadline for the filing of 5-year carryback claims.

If taxpayers that filed their 2001 tax returns prior to enactment of the Job Creation and Worker Assistance Act of 2002 did not make an election under IRC § 172(b)(3), they should be entitled to carry back their 2001 NOLs 5 years, assuming their carryback claims are timely filed within the applicable statute of limitations.

B. Taxpayers that filed a 2-year carryback claim are at a disadvantage compared to similarly situated taxpayers that did not file any carryback claim.

Rev. Proc. 2002-40 distinguishes between taxpayers depending upon whether the taxpayer has filed a 2-year carryback claim. Rev. Proc. 2002-40, § 5 is applicable to taxpayers with NOLs that filed a 2-year carryback claim, whereas Rev. Proc. 2002-40, § 6 is applicable to taxpayers with NOLs that had not filed a 2-year carryback claim.

If a taxpayer filed a 2-year carryback claim, Rev. Proc. 2002-40, § 5.01 requires the taxpayer to file a carryback claim using a 5-year period by October 31, 2002. In contrast, if a similar taxpayer with a NOL had not filed a 2-year carryback claim, Rev. Proc. 2002-40, § 6.02 provides that the taxpayer need do nothing and will be entitled to the 5-year carryback period “by operation of law.”

The foregoing distinction drawn by Rev. Proc. 2002-40 is not reasonable. It imposes an affirmative obligation on taxpayers that filed 2-year carryback claims before enactment of the 2002 tax legislation, but no obligation on taxpayers that did not file 2-year carryback claims. The same rule should apply to both. Under the general statutory rules, taxpayers may file amended tax returns carrying back NOLs any time before expiration of the statute of limitations under IRC § 6511 for the taxable year in which the NOL was incurred. Taxpayers that filed 2-year carryback claims before enactment of the 2002 tax legislation were not required to file those claims. Taxpayers can amend carryback claims any time before expiration of the statute of limitations.

IV. Proposal for Tax Technical Corrections Act of 2003

To provide relief for taxpayers described above, we would suggest that a new subsection (D) be added to Sec. 3(b) of the Tax Technical Corrections Act of 2003, as follows:

“(2) In the case of a net operating loss for a taxable year ending during 2001 or 2002—

* * *

(D) if no election was made under section 172(b)(3) on a tax return filed before enactment of the Job Creation and Worker Assistance Act of 2002, the carryback period under section 172(b)(1)(H) shall apply if a 5-year carryback claim is timely filed within the applicable period of limitations.”

This proposed provision would permit taxpayers that filed their 2001 tax returns before enactment of the 2002 tax legislation an option to carry back their 2001 NOLs either 2 years or 5 years. This flexibility seems appropriate in light of all the circumstances. Offering these taxpayers the flexibility of carrying back their NOLs 5 years, even though they failed to meet the October 31, 2002 deadline imposed by Rev. Proc. 2002-40, § 5.01, would be consistent with the objectives of the legislation.

We appreciate your attention to this matter. If you need any additional information, please feel free to contact me.

Very truly yours,

Donald A. Barnes

Burlington Northern Santa Fe Corporation
Fort Worth, Texas 76131
January 21, 2004

The Honorable William M. Thomas
Chairman
House Ways and Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

Pursuant to your request for written comments on H.R. 3654, the “Technical Corrections Act of 2003,” (“Introduced Act”). We appreciate the opportunity you have provided for receiving our comments on this legislation.

I would like to bring to your attention our concerns with the retroactive application of the “binding contract rule” included in the bonus depreciation provision of the Introduced Act, which we believe represents a substantive change to the bonus depreciation provision of the Job Creation and Worker Assistance Act of 2002 (“Job Creation Act”) and not a mere technical correction. Taxpayers who made business decisions on the basis of the existing law not only relied on those provisions in making investment decisions but have already filed tax returns for 2001 and 2002 on the basis of these rules. We request your assistance in modifying it to limit its application to the time period beginning December 8, 2003, which is the date the bill was first introduced in the House of Representatives.

As you know, the Job Creation Act provides a bonus depreciation deduction equal to 30% of the basis of qualified property in the year the property is placed in service. To be qualified property, (i) the property must have been acquired by the taxpayer after September 10, 2001, (ii) the original use of the property must commence with the taxpayer on or after September 11, 2001 and (iii) the taxpayer could not have entered into a written binding contract for the acquisition of the property before September 11, 2001. The Job Creation Act also provides that self-constructed property will be considered to be acquired by the taxpayer after September 10, 2001, if manufacture, construction, or production began after that date even if the taxpayer had a binding contract before September 11, 2001.

The Introduced Act would substantially alter the property qualifying for bonus depreciation. One result of these changes would be to deny bonus depreciation where there was a commitment in place before September 11, 2001 to acquire property or if construction commenced before September 11, 2001, even if the person that eventually acquires the property after the commitment date is not a direct party to those plans or a person related to a party to those plans. Therefore, a taxpayer who was unrelated to the earlier transaction and who qualified for bonus depreciation under the previous rules will now in 2003 be disqualified from such benefit. The existing rules accomplished their goals by bringing new investors and capital to market in situations the "technical corrections" will retroactively deem not eligible for these incentives.

The provisions of the Introduced Act are unduly burdensome on both taxpayers and the government and their application cannot be reasonably made in every instance. The retroactive application of the Introduced Act, which clearly changes the existing law, would especially harm capital intensive taxpayers that have made a series of investment decisions subsequent to the enactment of the Job Creation Act and prior to December 8, 2003 assuming an investment qualifies for bonus depreciation, which will be incorrect if the Introduced Act becomes law.

I would like to again request your support to modify the proposed "binding contract rule" by limiting its application to transactions entered into on or after December 8, 2003, which is the date this change in law first came to the general attention of taxpayers. Taxpayers that in reliance on the existing law entered into contracts after September 11, 2001 and placed the relevant property in service on or before December 8, 2003 can be assured that the property qualifies for bonus depreciation based on the rules in effect when they entered into their agreements.

Please contact Ms. Shelley Venick, Vice President and Tax Counsel, at 817-352-3400 should you have any questions or comments concerning the above. We appreciate your consideration of this matter and look forward to working with you on this issue.

Respectfully submitted,

Thomas N. Hund
Executive Vice President
Chief Financial Officer

Statement of Constance Logan, Iacopi, Lenz & Company Accountancy Corporation, Stockton, California

I. Introduction

The purpose of this comment is to suggest that section 168(k) be amended to clarify whether certain farmers who have elected out of the provisions of IRC 263A under section 263A(d)(3) and are therefore committed under section 263A(e)(2) to using the Alternative Depreciation (ADS Farmers) qualify for the special 50% 168(k) Bonus Depreciation. The Code is ambiguous regarding this issue, and both the Committee reports and the legislative Blue Book are silent about the application to these farmers. However, the Treasury Department issued pronouncements interpreting this section to exclude the ADS farmers from the benefits of Bonus Depreciation.

Impact: The farmers targeted by the Treasury rulings are essentially cash-basis small- to mid-sized farmers that have incurred pre-production or development costs (i.e. planting, fertilizer, irrigation, and so forth) for orchards and vineyards and have elected to expense rather than capitalize these costs. Farmers who are required to use the accrual method of accounting under sections 447 or 483 may not make this election. This 263A(d) election is irrevocable (except with the permission of the Secretary of the Treasury) and the 263A(e)(2) ADS requirement applies to the year that the development costs are incurred and to all subsequent years. It applies not just to development costs but to all depreciable property acquired by the farmers for use

in their farming business (i.e. harvesting equipment, sprinkler systems, new trees and vines, and so forth) in all the subsequent years. A farmer may have made an election 10 years ago to expense development costs and because of this will not qualify for the 50% Bonus Depreciation on new harvesting equipment that he purchases in 2003. While these farmers may only comprise a minority of farmers, their economic contributions are substantial, and if the Treasury Department's interpretation is correct, the farming industry as a whole will be adversely affected.

II. Ambiguous Code Language

Section 168(k) allows an additional first year depreciation deduction of 50%¹ of the cost of a qualified asset. The remaining balance of the cost of the asset is depreciated using the normal MACRS rates. To be a qualified asset, it must be new (the original use begins with the taxpayer) and have a cost recovery period (depreciable life) of 20 years or less. Further, it must be MACRS property, which is tangible property used in a trade or business or for the production of income and subject to an allowance for depreciation.² Unlike section 179, there is no dollar limit to the amount of Bonus Depreciation that may be claimed and no limit on the cost of property that qualifies.³ The Bonus Depreciation provisions are temporary and are scheduled to expire December 31, 2004.⁴ Farmers could potentially reap huge benefits if they are allowed to claim the Bonus Depreciation. Typical farm assets that would qualify if they were purchased new for the farm business are planting and harvesting equipment (5 year property), farm vehicles (5 year property), special purpose agricultural or horticultural buildings (10 year property), barns and silos (20 year property), irrigation systems (15 year property), and trees and vines⁵ (10 year property).

It is the complex interrelationship between the depreciation rules of Section 168(g) and (k) and the uniform capitalization rules of Section 263A(d) and (e) that provides the ambiguity that needs to be resolved.

IRC Section 168: Bonus Depreciation under section 168(k) is not applicable to businesses required to use the Alternative Depreciation System (ADS) under Section 168(g).⁶ The ADS is basically a straight-line depreciation system with longer depreciable lives unlike the MACRS accelerated system that uses shorter lives and higher rates (i.e. double the straight line rate). Section 168(k)(2)(C) specifically identifies 2 categories of property that are excluded from "qualified property" for Bonus Depreciation: (1) property to which the alternative depreciation applies under Section 168(g), and (2) Section 280F(b) (listed property with predominant personal use).⁷ Section 168(g) provides that the "depreciation deduction provided . . . shall be determined under the alternative depreciation system" for four specific categories of property: (1) Foreign use property, (2) Tax-exempt use property, (3) Tax-exempt bond financed property, and (4) Property identified by Executive Order.⁸ Use of the ADS method is also required if the taxpayer makes an election to use ADS under Section 168(g)(7).⁹ This section provides for a separate election to use the alternative depreciation system and does not identify any particular type of property. Pursuant to Section 168(k)(2)(C)(i)(I) this election will not eliminate the bonus depreciation on property for which this election is made.

In addition to those assets specifically identified in Section 168(g), two other code sections specify assets for which the use of the ADS is required under certain cir-

¹ This was originally 30% for assets acquired after Sept. 10, 2001 but was increased to 50% by the Jobs and Growth Tax Relief Reconciliation Act of 2003 for assets acquired after May 5, 2003.

² 2002 Tax Legislation, Law, Explanation and Analysis Job Creation and Worker Assistance Act of 2002 §305.

³ See IRC § 179 (restricting additional first year depreciation under that section to \$100,000 and eliminating the deduction if qualified property purchases exceed \$400,000 during the tax period).

⁴ Job Creation and Worker Assistance Act of 2002, P.L. 107-147, Act § 101(a) (March 9, 2002). This date is extended to December 31, 2004 by the 2003 Tax Act.

⁵ To qualify as "new" for bonus depreciation, trees and vines must be planted after Sept. 11, 2001 and produce a marketable crop before Jan. 1, 2006.

⁶ IRC § 168(k)(1)(C).

⁷ "(i) Alternative depreciation property. The term "qualified property" shall not include any property to which the alternative depreciation system under subsection (g) applies, determined: (I) without regard to paragraph (7) of subsection (g) (relating to election to have system apply), and

(II) after application of Section 280F(b) (relating to listed property with limited business use)."

⁸ IRC 168(g)(1)(A)-(D).

⁹ IRC 168(g)(1)(E).

cumstances. One is referenced in Section 168(k)(2)(C)(i)(II), Section 280F(b)¹⁰ (relating to “listed” property)¹¹ and one is not referenced, Section 263A(e) (relating to certain farmers). Section 280F(d) was specifically identified in Section 168(k)(1)(C)(i)(II) as being excluded from Bonus Depreciation. However, the language in Section 168(g) or 168(k) does notably not exclude farmers either by reference to farmers or to Section 263A(e)(2).¹² Certain farmers may be excluded under the broad phrase “property to which the alternative depreciation system under [168(g)] applies”¹³ depending on how this section and Section 263A(e) are interpreted. If the phrase “property to which 168(g) applies” encompasses Section 263A(e) and 280F(b) property, then it is redundant to add 280F(b) as another exception in Section 168(k)(2)(C)(i)(II).

Section 263A: Section 263A(d) Farmers’ election out of the Uniform Capitalization rules allows farmers to expense pre-production costs for orchards and vineyards rather than to capitalize these costs and postpone recovery until the trees or vines start producing. As a condition of making this election, the farmer must (1) use the ADS depreciation method and (2) recapture any capital outlay expended through 263A(d) as ordinary income rather than capital gain income upon the sale of the orchard or vineyard.

The provisions of 263A(d) and (e) apply to any farm crop with a pre-production period of 2 years or more but generally would apply only to trees¹⁴ and vines. The election is irrevocable (without the consent of the Secretary of the Treasury Department) and the ADS straight-line method applies prospectively to all assets purchased for farm use (not just the trees and vines or assets purchased during the pre-productive period).

If farm property of farmers who have elected out of the Uniform Capitalization Rules is “any property to which the alternative depreciation system under subsection (g) applies” then farmers would not be able to claim the Bonus Depreciation. This is precisely the phrase that is ambiguous and subject to differing interpretations. The key to resolving this ambiguity is an analysis of Legislative Intent regarding the application of 168(k) to ADS Farmers.

III. Analysis of Legislative Intent

When a statute is not clear on its face, legislative intent may be inferred from many extrinsic sources including the avowed purpose of the statute, the committee reports and other reference materials referred to by the lawmakers in making their decision, and the statute’s relationship to the whole legislative scheme currently and historically.

- A. Purpose: The expressed legislative intent of the Job Creation and Worker Assistance Act of 2002 was to create jobs and assist workers and to help the country recover from the economic effects of the September 11th tragedy. One way they intended to do this was by providing tax incentives to businesses, in the form of Bonus Depreciation in order to encourage purchases of new equipment and other assets. Encouraging capital investments in new assets would stimulate the demand for new assets and ultimately the increased manufacturing and supply of these assets thus creating more jobs. The investment in capital assets and the additional funds from tax savings would also stimulate the expansion of businesses with increased production and sales that also would require the hiring of new employees.

It is understandable why Congress would not allow the Bonus Depreciation for property that would be used outside of the United States,¹⁵ because this would stimulate foreign markets not the U.S. economy. It is also understandable why they would exclude listed property under Section 280F(b),¹⁶ because this property is only excluded if the personal use is 50% or more. So these would essentially be personal, not business assets. Also, it was the tax incentives that would provide the stimulus so it is equally understandable why Congress would exclude tax-exempt use property. It is not, however, understandable why Congress would intend to exclude ADS Farmers’ property. Farms are

¹⁰ Relating to Listed Property which is certain dual use property used more for personal than for business.

¹¹ See CCH Federal Tax Service §G:16.262 (including as listed property as any passenger automobile, transportation equipment, or computers).

¹² Reference to Code Section 263A(e)(2) was how the IRS and Treasury excluded certain farmers from the Bonus Depreciation rules.

¹³ IRC 168(k)(2)(C).

¹⁴ Other than citrus or almond trees.

¹⁵ See IRC 168(k)(2)(C) (referring to the excluded taxpayers in IRC 168(g)(1)).

¹⁶ IRC 168(k)(2)(C).

businesses that could hire new employees if they had tax incentives to help them expand by buying new assets. Also, a demand for new farm equipment would spur the economy by supporting increased manufacture of farm equipment. Further, farmers tend to hire unskilled labor, the group with the highest unemployment rate.

- B. **Committee Reports and Legislative Blue Book:** When Congress' intent is not clear from the actual language of a statute or the surrounding text, the intent may often be discerned from the congressional committee reports and if that is not conclusive, from the language or intent of other legislative publications. The staff of the Joint Committee prepared a legislative summary on March 22, 2002.¹⁷ The document lists four basic requirements for Bonus Depreciation but there is no mention of 263A(e)(2) or farmers in this entire document. Therefore, it is certainly not clear from this document that the legislators intended to exclude the 263A(2)(e) farmers.

The Jobs Growth and Tax Relief Reconciliation Act of 2003 (2003 Act) increased the bonus depreciation rate from 30%–50% and extended the applicable period. The committee reports for this Act do not address the 263A(e)(2) farmer issue or any of the specifically excluded types of property. This Act became law on May 28, 2003 which was after the publication of the IRS Revenue Procedure¹⁸ excluding ADS Farmers and after the legislative analysis contained in the “Blue Book,”¹⁹ but before the Treasury Department Temporary Regulation excluding ADS Farmers.²⁰ Does the failure to specifically exclude 263A(e)(2) from Section 168(k) bonus depreciation in the amendment to Section 168(k) mean that Congress was ratifying the position taken in the IRS Revenue Procedure or that Congress was not aware of the IRS position? It is here postulated that based on the totality of the information available to the legislatures at the time of the enactment, including committee reports and the Blue Book Explanation, they were unaware of either the Treasury position or the impact of 168(k) on the ADS farmers. No mention was made of either in any of the documents. The Blue Book specifically listed the four excluded categories of taxpayers in Section 168(g)²¹ and Section 280F(b) but did not mention 263A(e)(2) or farmers.

It is interesting to note that in June 2002 the Joint Committee staff prepared a summary for S. 312, the “Tax Empowerment and Relief for Farmers and Fisherman Act,”²² which proposed tax law changes that would help farmers. This summary included an overview of current law but did not mention the Section 263A(e)(2) farmers Bonus Depreciation dilemma. A logical inference is that the drafters were not aware of the adverse impact of the Treasury interpretation on certain farmers.

- C. **Legislative Scheme:** The staff of the Joint Committee on Taxation²³ explaining the 2002 Act indicated that the “present law” that was the starting point for the recommended Bonus Depreciation provision was Section 179 that allows an additional first year depreciation expensing option for certain property. There are many restrictions on the application of Section 179 most of which were minimized by the 2002 Act.²⁴ ADS Farmers are qualified to claim the benefits of Section 179. However, neither foreign use property nor tax-exempt use property are qualified Section 179 property,²⁵ and neither is Section 280F(d) property.²⁶ No effort was made to restrict ADS Farmers' use of Section 179. And, as was mentioned above, the Committee Reports are silent on the issue of farmer's depreciation.

¹⁷ Joint Committee on Taxation, *Summary of P.L. 107-147, the “Job Creation and Worker Assistance Act of 2002”* (JCX-22-02), March 22, 2002.

¹⁸ I.R.B. 2002-20, 963, April 29, 2002.

¹⁹ Joint Committee on Taxation's General Explanation of Tax Legislation Enacted in the 107th Congress (Blue Book), (JCS-1-03, January 24, 2003).

²⁰ I.T. Reg. 1.168(k)-1T.

²¹ Foreign use property, tax-exempt use property, tax-exempt bond financed property, and Executive Order property.

²² Joint Committee on Taxation, *Overview of Present Law and Selected Proposals Regarding the Federal Income Taxation of Small Business and Agriculture* (JCX-45-02), May 31, 2002.

²³ Technical Explanation of the “Job Creation and Worker Assistance Act of 2002.”

²⁴ Notably the amount that can be expensed was increased from \$24,000 to \$100,000 per year and the maximum dollar amount of Section 179 placed in service during the taxable year was raised from \$200,000 to \$400,000 thus qualifying more taxpayers for the deduction.

²⁵ IRC 179(d)(1); IRC 50(b).

²⁶ IRC 280F(d)(1) Coordination with Section 179.

Section 280F, which restricts depreciation on Luxury Autos and certain personal use property (listed property), was modified by the 2002 Act in two ways. The dollar limitation for deductions was increased and Section 280F(b) property that is used more than 50% for personal use was specifically excluded from the benefits of Section 168(k). The fact that this section, which is the only other section that requires the use of the ADS method, was specifically addressed by legislation whereas Section 263A(e)(2) was not addressed indicates that the impact of Section 168(k) on farmers may not have been brought to the attention of the legislators.

- D. Legislative History: There are numerous code sections that manifest the legislator's intent to provide tax benefits to farmers. A Congressional intent to exclude farmers from Section 168(k) Bonus Depreciation would seem counter-intuitive to all these other sections.
1. Section 263A(d): Allows farmers to elect to expense pre-productive costs rather than postponing cost recovery through delayed depreciation deductions. This initially came at a cost to the farmer but at the time of its enactment, it was considered beneficial for the farmer. In retrospect, any election under this section would not have been made if anyone realized Congress would pass a law with a retroactive negative impact such as Section 168(k) as interpreted by the IRS.
 2. Farmers' Income Averaging: This allows farmers to average income over a three-year period to help even out fluctuations in income and to take advantage of lower tax rates. When Congress realized that the Alternative Minimum Tax (AMT) interfered with the benefits of income averaging, they proposed a change to the AMT rules.²⁷
 3. Estimated Tax Payments: Farmers are not required to pay estimated taxes if they file their tax returns by March 1 of the following year and pay all taxes due at that time.
 4. Cash Method of Accounting: Most farmers are allowed to use the cash method of accounting which allows them to deduct expenses when paid and report income when received. Other comparably situated taxpayers generally must use the accrual method of accounting.²⁸
 5. Net operating loss carryback: Before the 2002 Tax Act, farmers were allowed to carry back net operating losses from the farming business for 5 years.²⁹ This was another mechanism to even out fluctuating income and it provided for immediate refund of taxes paid in past years. Other taxpayers were restricted to a 2-year carry back period.

IV. IRS and Treasury Department Interpretation of Section 168(k)

In April 2002 the Internal Revenue Service issued a Revenue Procedure regarding the application of Section 168(k) Bonus Depreciation and as part of their interpretation, summarily excluded farmers who had made the 263A election and as a result were using ADS to calculate depreciation.³⁰ The Treasury Department incorporated the IRS interpretation in a regulation issued on September 5, 2003.

- A. Revenue the IRS issued Procedure 2002-33 on April 29, 2002 to provide "procedures for a taxpayer to claim the additional 30% depreciation . . . provided by § 168(k)." ³¹ In Section 2 paragraph .04 the procedure states, "The additional first year depreciation must not be deducted for, among other things: (1) property that is required to be depreciated under the alternative depreciation system of § 168(g) pursuant to § 168(g)(1)(A) through (D) or *other provisions* under the Code (for example, property described in § 263A(e)(2)(A) or § 280F(b)(1)." (Italics added for emphasis). Throughout the six page Revenue Procedure this was the only reference to the 263A(e)(2) ADS farmers. Although there were pages of explanations for other provisions there was neither a reference to this statement nor any analysis.³² A few words in one part of a parenthetical phrase and the benefits of bonus depreciation are abolished for the ADS farmers.

²⁷ Joint Committee on Taxation, *Overview of Present Law and Selected Proposals Regarding the Federal Income Taxation of Small Business and Agriculture* (JCX-45-02), May 31, 2002.

²⁸ IRC § 446; IRC 447; IRC 448(a)(3).

²⁹ IRC § 172.

³⁰ I.R.B. 2002-20, 963, April 29, 2002.

³¹ I.R.B. 2002-20, 963, April 29, 2002. (Just 51 days after the enactment of P.L. 107-147 on March 9, 2002).

³² There was no analysis for Section 280F(d) either, however this code section was specifically identified in the Code.

Immediately after Section 168(k) was passed, commentators offered interpretations of how the 263A(d) election would affect farmers and all considered Section 168(k)(C) ambiguous and open to interpretation. After the IRS ruling there were no further comments in the tax literature.

- B. Temporary Treasury Regulation 1.168(k)-1T was issued September 5, 2003³³ to “provide the requirements that must be met for depreciable property to qualify for the additional first year depreciation deduction provided by Section 168(k).”³⁴ Using wording almost identical to the Revenue Procedure,³⁵ the regulation at 1.168(k)-1T(b)(2)(ii) provides “property will not meet the requirements of [168(k)] if the property is . . . (2) required to be depreciated under the alternative depreciation system of Section 168(g) pursuant to Section 168(g)(1)(A) through (D) or other provisions of the Internal Revenue Code (for example, property described in Section 263A(e)(2)(A) or Section 280F(b)(1)”³⁶ This was the only reference to Section 263A(e)(2) ADS farmers, and, as with the revenue procedure, there was no explanation or analysis. The IRS employee who authored both pronouncements, explained his reasoning in a letter dated December 2, 2003: “Because the alternative depreciation system of Section 168(g) applies to property the taxpayer made the election for under Section 263A(d)(3), this property is not eligible for the additional first year depreciation deduction. This result occurs because Section 168(k)(2)(C)(i) does not provide an exception for property the taxpayer made the election for under Section 263A(d)(3).”^{37,38} Based on this reasoning, it could equally be argued that because Section 168(k)(2)(C)(i) does not specifically exclude Section 263A(e)(2) from Bonus Depreciation (as it does Section 280F(b)), ADS farmers should be eligible for the deduction. It should be noted that both the IRS and the Treasury Department included 263A(e)(2) farmers in the same phrase with Section 280F(b) listed property although the latter was specifically excluded from 168(k) by the language of the code. The fact that these sections were not both mentioned in the code (and the fact that 263A(e)(2) was not mentioned in the code, Committee reports, or the Blue Book) should have prompted some analysis by the IRS of the intent of this section of the legislation. It is clear from the language of the code that Congress intended to exclude Section 280F(b) property. It is not clear that Congress intended to exclude Section 263A(2)(e) property. On the contrary, it is apparent that the issue of the ADS farmers regarding Bonus Depreciation was not considered by the legislature at all.

V. Conclusion

Based on the forgoing, this commentator recommends that Section 168(k)(2)(C) be amended to read as follows:

“168(k)(2)(C)(i)(I) without regard to paragraph (7) of subSection (g) (relating to election to have system apply), or Section 263A(e)(2)(A) (relating to the effects of a Section 263A(d)(3) election), and”

It is respectfully submitted that this amendment would clarify the legislative intent of the original enactment and would eliminate the uncertainty in the administration of IRC § 168(k) while extending the benefits of Bonus Depreciation to deserving farmers who have been inadvertently excluded.

³³T.D. 9091 (Sept. 5, 2003).

³⁴Preamble to I.T. Reg. 1.168(k)-1T.

³⁵Both the Revenue Procedure and the Temporary Regulations were authored by Douglas Kim from the IRS.

³⁶I.T. Reg. 1.168-T.

³⁷Letter dated Dec. 2, 2003 from Douglas H. Kim, Id. at No. 50-12306, Internal Revenue Service Department of the Treasury, Washington, DC 20024.

³⁸The “exceptions” in Section 168(k)(2)(C) are the property that does not qualify. Mr. Kim apparently meant to say “exclusion from the 168(g) exception.”

Statement of Investment Company Institute

The Investment Company Institute (the “Institute”)¹ strongly supports the Tax Technical Corrections Act of 2003 (“TTCA”)² and urges its prompt enactment. In particular, we support the technical corrections to the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (“JGTRRA”) that clarify rules relating to qualified dividend income (“QDI”) taxable at the new 15 percent maximum tax rate. The approximately 25 million mutual fund shareholders who invest through taxable accounts in funds holding equities would benefit from these changes to Internal Revenue Code Section 854³ (which provides the rules pursuant to which QDI received by a mutual fund beginning January 1, 2003 retains its character when paid by the fund to its shareholders).

Transition Relief From 60-Day Designation Requirement

Section 854(b)(2), as amended by JGTRRA, provides that the amount of any distribution by a fund that may be treated as QDI shall not exceed the amount designated by the fund “in a written notice to its shareholders mailed not later than 60 days after the close of its taxable year.” For funds with taxable years that ended more than 60 days before JGTRRA was enacted (*i.e.*, funds with January and February year-ends), there was no opportunity to make this 60-day designation for distributions made during the taxable year. Even for funds with later taxable year-ends, the ability to make prompt designations has been hampered by delays in the issuance of comprehensive Treasury guidance (particularly before the recent release of guidance regarding dividends from foreign corporations) and by the funds’ need to review 2003 transaction histories.

The TTCA would provide transition relief for 2003 from the 60-day designation requirement. Specifically, the TTCA would provide that, with respect to the taxable year of a fund ending on or before November 30, 2003, the period for providing notice of the qualified dividend amount, as required under Section 854(b)(2), does not expire prior to the date by which the fund must provide IRS Form 1099 information to shareholders in accordance with Section 6042(c) (*i.e.*, January 31, 2004).

Flow Through of QDI From Qualified Foreign Corporations and REITs

Under Section 854(b)(1)(B), as enacted in JGTRRA, if the aggregate dividends received by a fund are less than 95 percent of its gross income for the year, then shareholders can treat as QDI only the portion of the fund’s dividends designated by the fund as such. Section 854(b)(1)(C) limits the amount of dividends that a fund may designate as QDI to the amount of aggregate dividends received by the fund for the taxable year.

The definition of aggregate dividends provided by Section 854(b)(3) prior to enactment of JGTRRA excluded certain dividends that generally are treated as QDI and also included other dividends that generally are not treated as QDI. To address the under-inclusiveness of Section 854(b)(3), JGTRRA added new clauses (iii) and (iv) of Section 854(b)(1)(B) to expand the definition of aggregate dividends for purposes of clause (i) of Section 854(b)(1)(B) to include dividends received from qualified foreign corporations and certain dividends received from a real estate investment trust (“REIT”). To address the over-inclusiveness of the term “aggregate dividends,” JGTRRA added new Section 854(b)(5) to limit the amount that a fund can include in aggregate dividends, for purposes of Section 854(b)(1)(B), to the QDI of the fund.

The JGTRRA provisions designed to address the under-inclusiveness of Section 854(b)(3)—by expanding the definition of aggregate dividends—apparently do not apply for purposes of Section 854(b)(1)(C), which limits the amount of QDI the fund can designate under Section 854(b)(1)(B) to the amount of aggregate dividends received by the fund. Likewise, the JGTRRA provisions designed to address the over-inclusiveness of Section 854(b)(3)—by limiting the amount that a fund can include in aggregate dividends—apparently do not apply for purposes of the Section 854(b)(1)(C) limitation.

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,672 open-end investment companies (“mutual funds”), 605 closed-end investment companies, 108 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about \$7.149 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

² H.R. 3654, S. 1984.

³ All references to sections, unless otherwise indicated, are to sections of the Internal Revenue Code.

The effect of the JGTRRA changes not applying for purposes of Section 854(b)(1)(C) would be to prevent funds that do not receive at least 95 percent of their gross income from qualifying dividends from treating any dividends received from qualified foreign corporations and REITs as part of the aggregate dividends that may be designated as QDI.

To ensure that Section 854 operates as intended, the TTCA would modify the limitation on the designation of QDI and thereby clarify that dividends from qualified foreign corporations and eligible REIT dividends may flow through a fund to its shareholders.

Effective Date for Partnerships in Master Feeder Structures

The 15 percent maximum tax rate on QDI provided by JGTRRA applies to dividends received by individuals in taxable years beginning after December 31, 2002. In the case of dividends received by funds, JGTRRA applies to dividends received after December 31, 2002 (without regard to the fund's taxable year).

A recently issued IRS Announcement interpreting the JGTRRA effective date provisions (Announcement 2003-56) states that, in the case of partnerships with fiscal years beginning in 2002 and ending in 2003, no dividends received by the partnership during that fiscal year may be treated as qualified dividends, even if received during 2003. By its terms, this announcement would appear to apply to funds that invest in partnerships, including funds that are part of a master-feeder structure.

The master-feeder structure, which is common in the mutual fund industry,⁴ typically consists of one or more mutual funds, known as "feeder funds," with substantially identical investment objectives that pool their assets in a single investment pool, or "master fund," that is classified as a partnership for Federal income tax purposes. The feeder funds and the master fund typically have the same taxable year. Feeder funds, as partners in a partnership, do not receive dividends directly; instead, they take into income their distributive shares of the dividend income received by the master fund partnership pursuant to Section 702.

Under the effective date provision applicable to mutual funds, a mutual fund with a taxable year ending on June 30, 2003 would treat the new qualified dividend provisions as applying to dividends it received during the period from January 1, 2003 through June 30, 2003. We believe that this result was intended to apply without regard to whether the mutual fund received the dividends directly from the distributing corporation or through a master fund that held the stock of the distributing corporation.

The TTCA would modify JGTRRA by essentially providing partnerships with the same effective date that applies to funds. Under the TTCA, partnerships, like funds, would be permitted to treat as QDI the eligible dividends received after 2002, even if the partnership's fiscal year began before January 2003.

Mutual Fund Distribution of Subchapter C Earnings and Profits

JGTRRA does not include any specific provision pursuant to which a fund may treat as QDI a distribution of subchapter C earnings and profits that it acquired in a tax-free acquisition of a C corporation's assets or as a result of a C corporation converting to a mutual fund; these amounts must be distributed by the fund to maintain its status as a regulated investment company under subchapter M.

Subchapter C earnings and profits have been taxed at the entity level and hence may be distributed to the C corporation's shareholders as QDI. Shareholders in a fund that distributes Subchapter C earnings and profits received in situations described above likewise should be permitted to treat the distributed amounts as QDI. Treatment as QDI should not be forfeited merely because the Subchapter C earnings and profits are distributed by the fund rather than by the C corporation.

The TTCA would modify Section 854(b)(1)(C) to provide that the amount that may be designated by a fund as QDI under Section 854(b)(1)(B) shall not exceed the sum of QDI and "the amount of any earnings and profits which were distributed by the company for such taxable year in order to comply with the requirements of Section 852(a)(2)(B) and accumulated in a taxable year with respect to which this part did not apply."

Holding Period Requirement for Qualified Dividend Income

In order for a dividend on common stock to be treated as QDI under JGTRRA, the taxpayer must hold the stock on which the dividend is paid for at least 61 days. Sections 1(h)(11)(B)(iii) and 246(c). For this purpose, only days during the 120-day period beginning on the date that is 60 days before the ex-dividend date are taken

⁴ Feeder funds have approximately \$50 billion of assets in master funds holding equities.

into account. Also for this purpose, the taxpayer's holding period begins the day after the date on which the stock is acquired. Section 246(c)(3).

JGTRRA, as originally enacted, prevents a taxpayer who acquires common stock the day before the ex-dividend date from meeting the 61-day holding period requirement for that dividend. For example, if an individual acquires stock on July 30 that goes ex-dividend on July 31, the 120-day period begins on June 1 (60 days before the July 31 ex-dividend date) and ends on September 28 (59 days after the July 31 ex-dividend date). Because the taxpayer's holding period begins on July 31 (the day after the purchase date) and only 59 days remain (after July 31) in the 120-day period, the taxpayer can never meet the 61-day holding period requirement for that first dividend. The 2003 Form 1040 Instructions, reflecting JGTRRA as enacted, contain a similar example and indicate that such a dividend is not QDI.⁵

The TTCA would allow an investor who acquires common stock the day before it goes ex-dividend to meet the 61-day holding-period requirement by extending the 120-day holding period to 121 days—thereby providing a period that includes 60 days both before and after the ex-dividend date.⁶

SUMMARY POINTS

I. The Tax Technical Corrections Act of 2003 Should Be Enacted Promptly

The Investment Company Institute strongly supports the Tax Technical Corrections Act of 2003 ("TTCA") and urges its prompt enactment. In particular, we support the technical corrections to the Jobs and Growth Tax Relief and Reconciliation Act of 2003 ("JGTRRA") that clarify rules relating to qualified dividend income ("QDI") taxable at the new 15 percent maximum tax rate. These technical corrections would provide the approximately 25 million mutual fund shareholders who invest through taxable accounts in funds holding equities with the tax benefits intended by Congress when JGTRRA was enacted.

II. Effect of Technical Corrections on Mutual Fund Shareholders

A. Transition Relief From 60-Day Designation Requirement

The TTCA includes transition relief from the statutory requirements for timely designating the character of dividends paid. QDI designations for distributions made by funds for taxable years ending during 2003 are being made, taking this transition relief into account, by January 31, 2004 (the date by which the fund must provide IRS Form 1099 information to shareholders for payments made in 2003).

B. Flow Through of QDI From Qualified Foreign Corporations and REITs

The TTCA clarifies that dividends received by a fund from qualified foreign corporations and REITs that are eligible for QDI treatment do not inadvertently lose that eligibility when they flow through a fund to its shareholders.

C. Effective Date for Partnerships in Master Feeder Structures

The TTCA clarifies that JGTRRA provides investors in partnerships with the same effective date for QDI benefits that JGTRRA expressly provides to shareholders in mutual funds. Among other things, the clarification will permit fund shareholders who invest in a feeder fund that holds an interest in a master fund partnership (where the portfolio management is performed) to receive the same benefits as other fund shareholders.

D. Mutual Fund Distribution of Subchapter C Earnings and Profits

The TTCA clarifies that a fund shareholder will receive QDI treatment for dividends attributable to amounts previously taxed to a fund's predecessor.

E. Holding Period Requirement for Qualified Dividend Income

The TTCA clarifies that the period during which common stock must be held for 61 days to receive QDI treatment is 121, rather than 120, days (*i.e.*, 60 days both before and after the ex-dividend date). This clarification will permit an investor who acquires stock the day before it goes ex-dividend to meet the holding-period requirement.

⁵ See, 2003 Form 1040 Instructions, p. 23, Line 9b, ex. 2.

⁶ The TTCA also extends the holding period with respect to preferred stock from 180 to 181 days.

Jackson & Campbell, PC
 Washington, DC 20036
 January 23, 2004

Chairman William M. Thomas
 Committee on Ways and Means
 1102 Longworth House Office Building
 Washington, DC 20515-6348

Dear Chairman Thomas,

We appreciate the opportunity to comment on H.R. 3654/S. 1984, the “Tax Technical Corrections Bill of 2003.”ⁱ The TCB would correct a technical glitch involving dividends that individual taxpayers receive through passthrough entities. We urge the Congress to approve the correction promptly. We also urge the IRS quickly to announce that it will follow the anticipated technical correction in processing 2003 tax returns.

Context

Jobs and Growth Tax Relief Reconciliation Act of 2003ⁱⁱ

The 2003 Act taxes “qualified dividend income” of individuals at a maximum tax rate of 15%.ⁱⁱⁱ In general, this amendment applied to “taxable years beginning after December 31, 2002.”^{iv} The following special effective date rule was provided for regulated investment companies (“RICs”) and real estate investment trusts (“REITs”):

(2) Regulated investment companies and real estate investment trusts. In the case of a regulated investment company or a real estate investment trust, the amendments made by this section shall apply to taxable years *ending* after December 31, 2002; except that dividends received by such a company or trust on or before such date shall not be treated as qualified dividend income (as defined in Section 1(h)(11)(B) of the Internal Revenue Code 1986, as added by this Act).^v [Emphasis supplied.]

IRS Position

Announcement 2003-56

As a result of the 2003 Act, the IRS announced in Announcement 2003-56 changes in the reporting requirements for certain 2002 tax forms filed by entities with 2002-2003 fiscal years ending after May 5, 2003.^{vi} Although the Announcement primarily addressed the taxation of capital gains, it included the following note:

Note: Dividends received in a tax year beginning in 2002 and ending in 2003 are not qualified dividends, even if the dividends are received during 2003. Therefore, [i]ndividuals and estates with 2002-2003 fiscal years cannot have any qualified dividends for that tax year. Partnerships, S corporations, and estates with 2002-2003 fiscal years have no qualified dividends to pass through to their partners, shareholders, or beneficiaries.

ⁱ H.R. 3654, introduced in the House of Representatives December 8, 2003, and referred to the Committee on Ways and Means; S. 1984, introduced in the Senate December 9, 2003, and referred to the Committee on Finance (the “TCB”). On December 9, 2003, the Committees requested written public comments for the record on the TCB. See *ADVISORY from the Committee on Ways and Means*, “Thomas Announces Request for Written Comments on H.R. 3654, the Technical Corrections Act of 2003” (December 9, 2003), and *U.S. Senate Committee on Finance*, “Senators Introduce Tax Technical Corrections Bill” (December 9, 2003).

ⁱⁱ Public Law 108-27 [H.R. 2], May 28, 2003 (the “2003 Act”).

ⁱⁱⁱ 2003 Act, § 302(a), adding IRC Section 1(h)(11), which treats “qualified dividend income” of individuals as net capital gain for purposes of the maximum capital gain rate in IRC § 1(h). See also the Joint Explanatory Statement of the Committee of Conference, May 22, 2003 (the “Conference Report”), Section III B.

^{iv} 2003 Act, § 302(f)(1).

^v 2003 Act, § 302(f)(2).

^{vi} Announcement 2003-56, 2003-39 IRB 694 (September 29, 2003) (the “Announcement”). The Announcement referred to May 5, 2003 on account of the transitional rules in 2003 Act § 301(c) governing the taxation of net capital gains for taxable years which include May 6, 2003.

Example^{vii}

Assume, for example, that a partnership owns stock in a domestic corporation or a qualified foreign corporation.^{viii} The partnership uses as its taxable year a fiscal year ending September 30. Assume also that all of the partners are individuals who use the calendar year as their taxable years. After December 31, 2002 but on or before September 30, 2003, the partnership received dividends from a corporation in which the partnership owns stock. For its taxable year ended September 30, 2003, the partnership reports to the partners their respective distributive shares of these dividends.^{ix} The partners report their shares of the dividends on their individual tax returns for their taxable years ended December 31, 2003. According to Announcement 2003–56, the partners may not treat these passthrough dividends as qualified dividends. The result would be the same, according to the Announcement, in the case of an S corporation receiving dividends the prorata shares of which the S shareholders take into account on their individual tax returns for the taxable years in this example.

Proposed Technical Correction

The TCB would extend to additional passthrough entities the 2003 Act's special effective date rule applicable to REITs and RICs. Section 2(a)(5) of the Bill reads as follows:

(5) Paragraph (2) of Section 302(f) of the Jobs and Growth Tax Relief Reconciliation Act of 2003^x is amended to read as follows:

“(2) PASS-THRU ENTITIES—In the case of a pass-thru entity described in subparagraph (A), (B), (C), (D), (E), or (F) of Section 1(h)(10) of the Internal Revenue Code 1986, as amended by this Act, the amendments made by this section shall apply to taxable years ending *after* December 31, 2002; except that dividends received by such an entity on or before such date shall not be treated as qualified dividend income (as defined in Section 1(h)(11)(B) of such Code, as added by this Act).” [Emphasis supplied.]^{xi}

This amendment would take effect as if included in Section 302 of the 2003 Act.^{xii} The Staff of the Joint Committee on Taxation has explained the proposed technical correction as follows:

The provision provides that, in the case of partnerships, S corporations, common trust funds, trusts, and estates, Section 302 of the [2003] Act applies to taxable years ending after December 31, 2002, except that dividends received by the entity prior to January 1, 2003, are not treated as qualified dividend income. The [2003] Act provided a similar rule in the case of RICs and REITs.^{xiii}

Support for Proposed Technical Correction

The proposed amendment of the 2003 Act's effective date makes perfect sense and should be enacted for various reasons.

1. The proposed technical correction merely clarifies the general effective date. The 2003 Act provided that dividends received by individual shareholders are subject to tax at a rate not exceeding 15% if the dividends are received in taxable years of individuals beginning after December 31, 2002.^{xiv} Both the sub-

^{vii} Announcement 2003–56 does not contain this example. It is provided here solely to illuminate the issue that this comment letter addresses.

^{viii} Under IRC § 1(h)(11), “qualified dividend income” generally means dividends received during the taxable year from domestic corporations and qualified foreign corporations.

^{ix} See IRC § 702(a). The 2003 Act conformed § 702(a) to reflect the possibility of a partnership reporting qualified dividends to its partners. As amended by § 302(e)(8) of the 2003 Act, IRC 702(a)(5) now requires each partner to take into account separately: “(5) dividends with respect to which Section 1(h)(11) or Part XIII of subchapter B applies.” In this amended language, “Section 1(h)(11)” refers to the provision of the Code taxing individuals’ qualified dividend income as net capital gain. See also note 3.

^x As previously explained, § 302(f) of the 2003 Act states the effective date of IRC § 1(h)(11), which taxes qualified dividend income of individual taxpayers at the same rates as net capital gain. See notes 4 and 5.

^{xi} TCB § 2(a)(5). The entities cross referenced in IRC § 1(h)(10) are: RICs, REITs, S corporations, partnerships, estates, trusts, and common trust funds.

^{xii} TCB § 2(b).

^{xiii} Staff of the Joint Committee on Taxation, *Description of the “Tax Technical Corrections Act of 2003,”* JCX–104–03 (December 9, 2003), page 2.

^{xiv} “Under the House Bill, dividends received by an individual shareholder from domestic corporations are taxed at the same rates that apply to net capital gain.” House Bill as summarized

stantive rule and its general effective date^{xv} focus on the treatment of dividends, not by any intervening passthrough entity but, rather, by the person ultimately receiving and taxable on the dividends. The proposed technical correction merely clarifies that dividends are subject to the same treatment when received through a 2002–2003 fiscal year of a passthrough entity.

2. Passthrough dividends should not be taxed differently than directly received dividends. Dividends of individuals should qualify for the preferential rate whether received directly or through a passthrough entity, provided that (i) the individual receives the dividends in a taxable year of the individual beginning after December 31, 2002 and (ii) the entity passing through the dividends receives them after December 31, 2002.^{xvi} The Legislative History of the 2003 Act anticipated no different treatment of dividends received through passthrough entities having 2002–2003 fiscal years.

When Congress in the 2003 Act wanted the character of income to be determined at the level of a passthrough entity, Congress so provided. The 2003 Act's reduction of individual tax rates on net capital gains generally applied to taxable years ending on or after May 6, 2003.^{xvii} Transitional rules were provided for taxable years which include May 6, 2003.^{xviii} In applying these transitional rules to capital gains received through passthrough entities, Congress directed that the determination of when gains and losses are properly taken into account shall be made at the entity level.^{xix} Congress did not similarly require that the character of dividends (as qualified dividend income) be determined at the level of a passthrough entity. Consequently, whether or not dividends received through passthrough entities qualify to be taxed at the 2003 Act's reduced rates should be determined at the individual recipient's level.

3. The 2003 Act's special effective date for dividends received through RICS and REITs makes even more sense for other types of passthrough entities. REITs and RICs are hybrid entities. They technically are subject to tax as entities separate from their owners. They typically pay no tax provided that they distribute sufficient income to their owners.^{xx} The 2003 Act provided rules for determining the extent to which REITs and RICs "pass through" qualified dividend income to their shareholders.^{xxi}

Partnerships and S corporations are pure passthrough entities. They generally are not subject to tax as entities separate from their owners.^{xxii} Partners and S corporation shareholders are subject to tax on their respective shares of the entity's income regardless of whether or when distributed. This flow through income has the same character as if realized directly from the source from which the partnership or S corporation realized it.^{xxiii} Therefore, dividends that a partnership or an S corporation receives after December 31, 2002 should be taxable to the entities' owners (partners and S shareholders, respectively) as though the owners received the dividends directly.^{xxiv}

in the Conference Report, Section III B. The 2003 Act's reduction of individual tax rates on capital gains and dividends are scheduled to sunset for taxable years beginning after December 21, 2008. 2003 Act, § 303.

^{xv} 2003 Act, § 302(f)(1).

^{xvi} In some cases, an individual may receive dividends through two or more vertical levels or "tiers" of passthrough entities. Treasury regulations or other administrative guidance should provide that such dividends qualify for the preferential rate only if no entity in the tiered structured received the dividends before January 1, 2003.

^{xvii} 2003 Act, § 301(d)(1).

^{xviii} 2003 Act, § 301(c).

^{xix} 2003 Act, § 301(c)(4).

^{xx} IRC §§ 852(b) and 857(b).

^{xxi} See IRC §§ 854(b)(1)(B) and 854(b)(5) (RICs), as amended by 2003 Act, § 302(c), and IRC § 857(a)(2) (REITs), as amended by 2003 Act, § 302(d).

^{xxii} Under targeted exceptions to this construct, S corporations are subject as entities to tax on their built-in gains and excess passive investment income and to a LIFO recapture tax. See IRC sections 1374, 1375, and 1363(d).

^{xxiii} IRC §§ 702(b) and 1366(b). Congress should consider amending IRC § 1366(a)(1) to clarify that qualified dividends are a "separately computed" item of S corporations. Compare IRC § 702(a)(5) as amended by the 2003 Act.

^{xxiv} Similarly, the 2003 Act's amendment of IRC § 702(a)(5) treating a partnership's qualified dividends as a "separately stated item" should be interpreted consistently with the proposed technical correction, i.e., by reference to the taxable years of the partners to whom the partnership reports the dividends. See Letter from Richard M. Hervey of November 25, 2003 to Michael S. Novey, Associate Tax Legislative Counsel, U.S. Department of the Treasury, 2004 TNT 1–27 (January 12, 2004).

Coordination With Internal Revenue Service

The issue of how to treat dividends received through fiscal year 2002–2003 pass-through entities arises in preparing entity and individual tax returns for 2003. Returns of entities categorizing the dividends must be filed (absent extensions) within either 2.5 months or 3.5 months after the end of the entity’s fiscal year.^{xxv} The pass-through dividends must be correctly reported on the returns of individual partners and shareholders. Calendar-year partners and S shareholders generally must file their 2003 returns (absent extensions) by April 15, 2004.^{xxvi}

We urge the IRS quickly to announce that in processing returns for 2003 tax years it will follow the TCB’s anticipated clarification as though enacted. As previously explained, the proposed technical correction merely clarifies the general effective date of the 2003 Act’s taxation of qualified dividends. Announcement 2003–56 should be modified accordingly.^{xxvii}

Thank you for carefully considering these comments. Should you want to discuss them, please feel free to call me at 202–457–4278 (through January 31, 2004) or 202–452–7965 (beginning February 1, 2004).

Sincerely,

Michael J. Grace

National Association of Real Estate Investment Trusts
Washington, DC 20006
January 22, 2004

The Honorable William M. Thomas
Chairman
House Ways and Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Thomas:

Pursuant to the instructions contained in Ways and Means Committee Press Release No. FC–10, this statement is made by the National Association of Real Estate Investment Trusts® (“NAREIT”) regarding H.R. 3654, the “Tax Technical Corrections Act of 2003” (“TTCA”).

NAREIT is the national trade association for real estate companies. Members are REITs and other publicly-traded businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses. REITs are companies whose income and assets are mainly connected to income-producing real estate. By law, REITs regularly distribute most of their taxable income to shareholders as dividends. NAREIT represents approximately 170 REITs or other publicly-traded real estate companies, as well as over 1,300 investment bankers, analysts, accountants, lawyers and other professionals who provide services to REITs.

NAREIT strongly supports the TTCA and urges its enactment. NAREIT specifically would like to thank the Ways and Means Committee for the helpful and appropriate changes relating to REIT dividends included in the TTCA.

Among other items, the TTCA would provide technical corrections to Public Law No. 108–27, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (“JGTRRA”). As you know, JGTRRA provides that the “qualified dividend income” (“QDI”) of non-corporate taxpayers is taxed at the same rate as “net capital gain,” at a maximum rate of 15%. JGTRRA’s policy goal in reducing the tax rate applicable to QDI was to minimize the double taxation (at the corporate and shareholder levels) otherwise applicable to income earned by corporations.

JGTRRA permits the following type of REIT dividends to qualify for this lower rate:

^{xxv} S corporations must file their returns within 2.5 months after the end of the tax year. Partnerships, trusts, and estates must file their returns within 3.5 months after the end of the tax year. IRC §§ 6072 and 6037.

^{xxvi} IRC § 6072.

^{xxvii} The proposed technical correction and the IRS’ adopting it would not prevent recipients of dividends from electing to treat them as investment income under IRC § 163(d) rather than as qualified dividend income. See IRC §§ 1(h)(11)(D)(i) and 163(d)(4)(B), as amended by § 302 of the 2003 Act.

(1) distributions by the REIT of income attributable to dividends from a taxable REIT subsidiary ("TRS") or other corporation; (2) distributions attributable to income on which tax was payable in the previous year due to distributing less than 100% of its REIT taxable income; and (3) distributions of income on which tax was payable for the previous taxable year due to the "built in gains" tax under the § 337(d) regulations, in both cases less the tax payable on such income.

Although JGTRRA provides for these three items to qualify as QDI when distributed by a REIT, there is some ambiguity in the JGTRRA's statutory language. Specifically, there is ambiguity under JGTRRA as to whether a REIT is "treated as receiving" QDI from a TRS and ambiguity as to whether a mutual fund may distribute QDI attributable to REIT distributions. Both individual taxpayers who invest in REITs directly and through mutual funds, as well as the entire REIT industry, could benefit from clarifications to this language.

Furthermore, consistent with the policy goal of minimizing double taxation applicable to corporate-earned income, REIT distributions of "earnings and profits" earned by C corporations (and therefore already subject to tax at the corporate level) should be permitted to qualify as QDI. Accordingly, NAREIT welcomes the provisions in the TTCA that would incorporate these changes.

I would be pleased to discuss NAREIT's comments with you in more detail. Please contact me at (202) 739-9408 if you have any questions. Thank you.

Sincerely,

Tony M. Edwards
Senior Vice President & General Counsel

Perkins & Company, PC
Portland, Oregon 97204
January 22, 2004

Chairman William M. Thomas
House Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Thomas:

We are hereby requesting clarifying language (or Joint Committee explanation with similar effect) with respect to the Tax Technical Corrections Act of 2003, Section 3(b)(2)(C), and IRC Section 172(j) of the Internal Revenue Code, as enacted by the Job Creation and Workers Act of 2002 (2002 Act). The purpose of the clarifying language would be to ensure that the five year net operating loss (NOL) carryback provision from the 2002 Act would be implemented by the IRS consistent with the plain language of the statute at IRC Section 172(j) and Congressional intent. IRC Section 172(j) states that the five year carryback is mandatory unless the taxpayer elects otherwise.

The clarifying language suggested would be as follows:

To provide the result intended by IRC Section 172(j) and IRC Section 172(b)(1)(H) as further explained below, and to disadvantage no taxpayer, new subsection "(D)" [new subsection 3(b)(2)(D)] could be added to section 3(b) of the Tax Technical Corrections Act of 2003 as follows:

"(D) if no election was made under section 172(b)(3) or section 172(j) on a tax return filed before enactment of the Job Creation and Worker Assistance Act of 2002, the carryback period under section 172(b)(1)(H) shall apply if a 5-year carryback claim is timely filed within the applicable period of limitations."

Although the above would be the clearest method of ensuring the proper result, if as a practical matter, merely providing clarifying language via the Joint Committee explanation is the only realistic approach, we would suggest as an alternative the following language be incorporated in the Joint Committee's discussion of the "five-year carryback of net operating losses" contained in its explanation with respect to the Tax Technical Corrections Act of 2003:

"The filing of a two year net operating loss carryback for a year ending in 2001 or 2002, where such two year loss carryback was filed **before** the enactment of the Job Creation and Workers Act of 2002 on March 9, 2002, shall not

be construed to be an election under section 172(j) to elect out of the 5 year carryback period (i.e. no deemed election will be forced upon a taxpayer), if the taxpayer timely files, or has filed, an amended return or tentative carryback adjustment for such year within the otherwise applicable period of limitations under IRC section 6511 or 6411 reflecting the 5 year loss carryback.”

Explanatory Support for Requested Clarification

The clarifying language does no harm to any taxpayer that relied on the administrative guidance provided in section 5 of Revenue Procedure 2002–40. Any taxpayer who relied on that guidance desiring to elect out of the 5 year carryback period by having a previously filed 2 year carryback constitute such election, will obtain that result even with the clarifying language (such taxpayer has to do nothing further to obtain the desired result).

On the other hand, where a taxpayer relied on the plain language of the statute in IRC section 172(j) [and the historical norm with respect to such elections, that the taxpayer must make an affirmative election to avoid the mandatory carryback period], and in good faith reliance on the statute, took no affirmative action to elect out of the 5 year carryback period (because it wanted a 5 year carryback to apply), such taxpayer should not have a deemed election to forego the 5 year carryback period forced upon it. A taxpayer relying on the plain language of section 172(j) and the historical norm for such elections (that the taxpayer must affirmatively elect out), had no reason to anticipate that through administrative guidance (Revenue Procedure 2002–40, section 5.02) a deemed election would be forced on it at an arbitrary date, such date being potentially years before the taxpayer otherwise anticipated that the amended return was required to be filed under pursuant to the normal period of limitations under IRC section 6511.

The fact that a taxpayer properly filed a 2 year NOL carryback before section 172(j) was enacted (e.g. prior to March 9, 2002) could not be properly construed to indicate the taxpayer desired to elect out of the 5 year carryback period. Properly construed, it is merely evidence that the taxpayer sought to use the NOL carryback to the fullest extent possible, under the law that existed at the time, which allowed only a 2 year carryback.

In an illustrative example we are familiar with, the taxpayer had a fiscal year end 3/31/01 return which generated an NOL. The loss year return (Form 1120) for FYE 3/31/01 was filed on October 11, 2001, and the 2 year NOL carryback on Form 1139 (the only carryback allowed by law at that point) was filed immediately after October 11, 2001 (during October 2001). The 2002 Act was then passed 5 months later on March 9, 2002, containing section 172(b)(1)(H), which mandates a 5 year NOL carryback for the loss for FYE 3/31/01, unless the taxpayer elects out of the 5 year carryback period under section 172(j).

The taxpayer had no desire to elect out of the 5 year carryback period, and understood that per the plain language of the statute at section 172(b)(1)(H) a 5 year carryback was mandatory, but that the statutory period of limitations allowed the amended return to report the 5 year loss carryback to be filed as late as October 11, 2004.

The taxpayer filed a Chapter 11 bankruptcy petition on April 10, 2002, before the taxpayer was able to have a Form 1120X to claim the 5 year carryback prepared. As part of the bankruptcy proceeding the taxpayer (which did not have in-house tax counsel or in-house cpas) was not able to engage third party tax advisors, and had no such advisors when Revenue Procedure 2002–40 was issued on 5/22/2002.

The taxpayer correctly understood the statute under section 6511(d)(2) allowed the 5 year NOL carryback claim (Form 1120X) to be filed within 3 years of the date the loss year return was filed. Therefore the taxpayer had until 10/11/2004 to file the 5 year carryback claim under well known period of limitation rules. The taxpayer remained in bankruptcy proceedings through 10/31/2002, and was never aware of the administrative acceleration provision within Revenue Procedure 2002–40, section 5, which purports to force a deemed election under section 172(j) onto them (if the Form 1120X was not filed by 10/31/2002). The taxpayer filed the 5 year carryback claim as soon as possible after it became aware of the issue, filing Form 1120X to carry the FYE 3/31/01 NOL back 5 years on 1/3/2003. The IRS Service Center rejected the claim (relying on Rev. Proc. 2002–40, section 5), and despite efforts of the Taxpayer Advocate Office, has thus far refused to process the claim.

We have tried to resolve the matter administratively through multiple channels at the IRS without success. We initially contacted the author of Revenue Procedure 2002–40, Martin Scully. He indicated agreement that the result was inequitable under the facts presented, and indicated that the 10/31/02 required action date contained in section 5 of Rev. Proc. 2002–40 was arbitrarily selected. However, he said that he could not provide any relief, and suggested we file the amended return re-

porting the 5 year carryback although he was not sure if it would be accepted. We then contacted the Taxpayer Advocate Office, and the representative there, Marron Dooney, agreed the claim had merit and should be processed, but was unable to convince the IRS Service Center. The taxpayer is pursuing its remaining administrative appeal rights within the IRS, but the concern is that unless there is language clarifying that the deemed election provision of Rev. Proc. 2002-40, section 5, is inappropriate and contrary to the statute, it will be difficult to obtain an equitable and just appeals decision.

Note that a similarly situated taxpayer, with a FYE 3/31/01 loss year, who has done nothing except file its loss return on 10/11/2001, would still have until 10/11/2004 to file its 5 year loss carryback return on Form 1120X. In the example above, it is only the fact the taxpayer timely filed its 2 year carryback return (**before the 5 year carryback statute existed**), that it is denied by Rev. Proc. 2002-40 its statutory right to a 5 year carryback period.

There is no advantage being gained by the taxpayer(s) via the requested clarification. There is no new information relating to the 2 or 5 year carryback period that is available to any taxpayer after 10/31/02 that was not available to the taxpayer before that date. So allowing the taxpayer to file its 5 year carryback under the normal (3 year) period of limitations rules does not create any advantage for the taxpayer as compared to what the statute allowed. The clarifying language also does not disadvantage any taxpayer that was aware Rev. Proc. 2002-40 existed, and desired a 2 year carryback period, and therefore intentionally let the 10/31/2002 date pass. If that was their desire, they need not take any additional action and they have obtained the result they desired.

Thank you for your assistance with this matter. You can reach the undersigned at (503) 221-7565 or the address indicated above if you have any questions or wish clarification.

Very truly yours,

Christopher J. Loughran
CPA & Shareholder

Vinson & Elkins, LLP
Washington, DC 20004
January 23, 2004

The Honorable William M. Thomas
Chairman
House Ways and Means Committee
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Thomas:

In response to your request for comments on H.R. 3654, the Tax Technical Corrections Act of 2003, we are hereby submitting an additional provision for inclusion in the bill.

The need for the proposed technical correction arises because the Internal Revenue Service has recently asserted a change in its position regarding the treatment under the foreign tax credit rules of certain business arrangements that have been excluded from partnership treatment by virtue of having made an election under section 761(a) of the Internal Revenue Code.¹ These co-ownership arrangements are referred to as "Elect-Out Arrangements," and the election out is a common fixture of oil and gas operating agreements.

The tax code has provided an election for co-owners to be excluded from partnership treatment under certain circumstances since 1954, and oil and gas joint venturers have relied on this feature in order to be taxed as co-owners of oil and gas property rather than as partners in a partnership.² In the absence of an election,

¹ All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

² An Elect-Out Arrangement is generally characterized by (i) the direct co-ownership of undivided interests in property rather than ownership through a partnership or other legally recognizable entity, (ii) the right of each co-owner separately to take in kind and dispose of the property produced or extracted, and (iii) prohibitions on joint marketing activity, whether directly or through the grant to any co-owner of collective irrevocable representative capacity. See Treas. Reg. § 1.761-2(a)(3).

co-ownership of oil and gas property would be treated for Federal income tax purposes (but not for any other legal purpose) as a partnership among the co-owners. Thus, an Elect-Out Arrangement generally is taxed as a direct, rather than indirect, property investment by each co-owner.

Historically, the sale of an interest in a jointly-owned property held through an Elect-Out Arrangement has been treated for tax purposes as a sale of the co-owner's interest in the underlying assets. Recently, however, the Internal Revenue Service has asserted that this well-settled characterization should not apply for foreign tax credit purposes, based on its interpretation of the combined effect of two disparate statutory changes—one to the foreign personal holding company rules made in 1988 and the other to the foreign tax credit limitation rules of section 904(d) made in 1993. Section 1012(i)(18) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) amended section 954(c)(1)(B) of the Code to include gain on the sale of an “interest in a . . . partnership” in the definition of foreign personal holding company income. Section 904(d)(2)(A)(i) cross references section 954(c)(1)(B) to define passive income for purposes of the foreign tax credit separate basket limitations. Section 13235(a)(2) of the Omnibus Reconciliation Act of 1993 (OBRA) amended section 904(d)(2)(A)(iii) to remove foreign oil and gas extraction income (FOGEI) from a list of specific exclusions from the definition of passive income for section 904 purposes.

Asserted IRS Position. The IRS is asserting that (i) because section 954(c)(1)(B), as amended by TAMRA, by its terms specifically refers to a partnership interest, a section 761(a) election will not preclude application of the provision, and (ii) because section 904(c)(2)(A)(iii), as amended by OBRA, no longer specifically excludes FOGEI from passive income characterization, the fact that any gain on a disposition of an interest held through an Elect-Out Arrangement involving foreign oil and gas producing properties is FOGEI does not prevent its treatment as “passive income” for purposes of section 904(d). The IRS refuses to undertake an analysis of the interdependence of the foreign personal holding company and foreign tax credit rules with the partnership rules of Subchapter K, ignoring judicial authority and prior IRS interpretation. Under the IRS approach, foreign oil and gas extraction taxes cannot be credited against U.S. tax liability with respect to gain on the sale of an undivided interest in a foreign oil and gas concession which has an Elect-Out Arrangement in effect. The IRS is attempting to treat the sale as the sale of a partnership interest rather than as the sale of the co-owned assets.

Proposed Technical Correction. A correct reading of the foreign personal holding company rules would give effect to the section 761(a) election. Section 954(c)(1)(B) should be amended to make clear that a sale of an interest in a co-ownership arrangement that has in effect a valid election under section 761(a) will not be treated as a sale of a partnership interest but instead will be treated as a sale of the underlying assets of such arrangement.

Reasons for Change. The proposed technical correction, which would reflect current law, is consistent with Congressional intent, judicial authority, and IRS interpretation contemporaneous with enactment of the 1988 statute. In addition, this technical correction would parallel the technical correction to section 1031(a) Congress enacted in 1990, which expressly provided that an interest in a co-ownership arrangement for which a valid section 761(a) election is in effect shall not be treated as a partnership interest for section 1031 purposes, but rather as an interest in the underlying assets.³ Congress enacted this technical correction in direct response to an indication that the IRS intended to interpret the statute to the contrary, and related its effective date back to the 1984 change to section 1031 that excluded exchanges of interests in partnerships from favorable nonrecognition treatment.⁴

Prior to 1988, it was well settled that the sale of an interest in an Elect Out Arrangement was treated as the sale of the underlying assets of the organization for purposes of determining the appropriate section 904 foreign tax credit basket.⁵

The TAMRA change relates to revisions to section 954 contained in the Tax Reform Act of 1986. The legislative history accompanying the 1986 legislation makes clear that Congress intended to treat gain from the sale of property which does not generate active trade or business income as passive for purposes of the foreign personal holding company rules. The legislative history for the TAMRA change does not indicate any further reason for including gain from the sale of a partnership interest in section 954(c)(1)(B), nor is any reference made to the existence of Elect-Out Ar-

³Omnibus Budget Reconciliation Act of 1990, P.L. No. 101-508, § 11703(d)(1).

⁴Deficit Reduction Act of 1984, P.L. No. 98-369, § 77(a).

⁵See Priv. Ltr. Rul. 87-26-061 (April 1, 1987).

rangements. It is reasonable to infer that the treatment of sales of interests in Elect-Out Arrangements in the oil and gas industry was not addressed at the time because (i) they were not treated as sales of interests in partnerships, based upon judicial authority, existing IRS position, and industry practice, (ii) they did not give rise to passive income or gain from their operation or disposition, and (iii) in any event the income from the sale of an interest in an Elect-Out Arrangement with respect to an oil and gas working interest constitutes FOGEI, which at the time was expressly excluded from the term passive income in section 904(d).

The OBRA legislative history makes clear that the amendment to section 904(d)(2)(A)(iii) some 5 years later was intended to subject interest income earned on working capital in an oil and gas extraction business to treatment as passive income under section 904, notwithstanding its character as FOGEI. No reference to passive treatment for any other type of FOGEI appears in the legislative history. There simply is no evidence Congress intended to alter the treatment of gain from the disposition of an undivided interest in an oil and gas property held through an Elect-Out Arrangement under section 904.

Under existing judicial authority, a section 761(a) election applies to negate the applicability of all provisions within Subchapter K and all provisions outside of Subchapter K that are interdependent with Subchapter K. The determination of interdependence properly is based on all the relevant facts and circumstances.

The first case to consider the scope of the section 761(a) election was *Bryant v. Commissioner*.⁶ The Tax Court held that, despite the existence of a section 761(a) election, a joint venture should be treated as a partnership for purposes of section 48(c), and therefore, a limitation on the investment tax credit in section 48(c) should be applied both to the Elect-Out Arrangement as an entity and to the participants therein. In explaining its reasoning, the Court noted that, “In our opinion, sections 761(a) and 48(c)(2)(D) are not interdependent.”⁷

An inflexible rule whereby a section 761(a) election does not apply to *any* Code section outside of Subchapter K would be unworkable, and there is universal agreement that there are clearly *some* sections outside of Subchapter K to which a section 761(a) election applies.⁸ Non-Subchapter K Code provisions that require the filing of a partnership return or the computation of partnership income are numerous. Without the flexibility provided by an interdependence analysis, virtually all co-ownership arrangements that have made a valid section 761(a) election could be forced to adhere to the provisions of Subchapter K, which in effect would nullify the elect-out provision. Accordingly, subsequent court decisions and IRS rulings have interpreted *Bryant* as holding that a section 761(a) election is applicable to a Code section outside of Subchapter K only if the section is “interdependent” with Subchapter K.⁹

In the most recent case dealing with the interdependence test, *Travelers Insurance Co. v. United States*, the Court of Federal Claims held that a special rule applicable to “partnerships” in former section 907(c)(3)(D) (now section 907(c)(3)(C)) was interdependent with Subchapter K and therefore inapplicable to an Elect-Out Arrangement.¹⁰ The taxpayer in *Travelers* had argued that because former section 907(c)(3)(D) expressly provided that FOGEI and FORI includes a taxpayer’s “distributive share of partnership income,” the section 761(a) election had no effect on section 907(c)(3)(D), and therefore the taxpayer should be treated as a partner of a partnership for purposes of this section. The Government argued that section 907(c) was inapplicable because the taxpayer elected under section 761(a) not to be treated as a partner under Subchapter K of the Code.¹¹ The Court held that the Elect-Out Arrangement was not a partnership for purposes of section 907(c) despite the fact that section 907(c)(3)(D) specifically referred to partnerships. The Court ex-

⁶ 46 T.C. 848 (1966), *aff’d.*, 399 F.2d 800 (5th Cir. 1968).

⁷ *Bryant*, 46 T.C. at 864.

⁸ See Rev. Rul. 83-129, 1983-2 C.B. 105; Priv. Ltr. Rul. 79-26-088; Priv. Ltr. Rul. 79-30-028; Priv. Ltr. Rul. 79-38-046.

⁹ See McMahon, *The Availability and Effect of Election Out of Partnership Status Under Section 761(a)*, 9 Va. Tax Rev. 1, 32 (1989). The IRS, however, apparently based on *dicta* in *Madison Gas & Electric Co. v. Commissioner*, 72 T.C. 521 (1979), *aff’d.* 633 F.2d 512 (7th Cir. 1980) and *Cokes v. Commissioner*, 91 T.C. 222 (1988), applies this rule counter-intuitively, *i.e.*, only if the non-Subchapter K Code provision in question does not specifically refer to partnerships. Logically, it would seem that a statutory reference to partnerships would increase the likelihood of, rather than negate, an interdependency of the provision with Subchapter K.

¹⁰ 28 Fed. Cl. 602 (Ct. Fed. Cl. 1993), *rev’d on other grounds*, 303 F.3d 1373 (Fed. Cir. 2002).

¹¹ Ironically, the IRS is claiming with respect to section 954(c)(1)(B) that the inclusion of the term “partnership” in the statute *per se* causes the section not to be interdependent with Subchapter K. In *Travelers*, it was the taxpayer that was arguing the inclusion of the term “partnership” in section 907(c) resulted in *per se* non-interdependence, and the government was arguing for a facts and circumstances application of interdependence.

plained that “section 907(c) and Subchapter K are plainly interdependent as the latter defines the terms of the former.”¹²

The IRS has itself concluded that the application of the section 761(a) election should not be strictly limited to Subchapter K. For example, in Revenue Ruling 83-129, the Service held that section 761(a) extended to section 616, and that as a result, two joint venturers who had elected out of Subchapter K could make different individual elections under sections 616(a) and 616(b). General Counsel Memorandum 39043, issued in 1983, supported this position, stating that, “if the limitation or rule outside of Subchapter K [cannot] be applied without doing violence to the concept of electing out of Subchapter K and computing income and deductions at the partner level,” such limitation or rule is “interdependent” with (and subject to) section 761(a).¹³

So far as the foreign personal holding company rules in section 954(c)(1)(B)(ii) relate to partnership interests, they are clearly interdependent with the partnership rules of Subchapter K—computation of the amount of gain from the disposition of a partnership interest under section 954(c)(1)(B)(ii) would require the calculation of its basis through application of sections 705, 701, 702, and 752, all of which are inapplicable to Elect-Out Arrangements. The results of the interdependence analysis show that the section 761(a) election must be given effect for purposes of section 954(b)(1)(C).

Finally, the IRS has consistently treated the sale of an interest in a domestic Elect-Out Arrangement as the disposition of the seller’s proportionate share of the underlying assets, with the character of the gain or loss determined by the nature of the underlying assets. Recent technical advice and field service advice memoranda contain detailed analysis supporting this approach.¹⁴ However, none of this analysis supports treating the sale of a foreign Elect-Out Arrangement differently from the sale of a domestic Elect-Out Arrangement.

Based on the foregoing, adoption of the proposed technical correction to section 1012(i)(18) of TAMRA would properly reflect Congressional intent and the appropriate scope of section 761(a).

Thank you for your consideration of this proposal. If you have any further questions or need any additional information, please do not hesitate to contact us.

Respectfully submitted,

Christine L. Vaughn and Thomas Crichton, IV

Washington, DC 20515
January 15, 2004

The Honorable Bill Thomas
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

In response to your request for written comments on H.R. 3654, the Tax Technical Corrections Act of 2003, I hereby submit the following request.

With Reps. Crane and McCrery as original cosponsors, I introduced a bill on April 11, 2003 that would amend the Internal Revenue Code of 1986, to allow certified U.S. legal tender coins to be acquired by individual retirement accounts and other individually directed pension plan accounts. That bill, H.R. 1820, was referred to Ways and Means Committee.

I feel H.R. 3654 is an appropriate vehicle for H.R. 1820 because H.R. 3654 contains technical corrections to the Taxpayer Relief Act of 1997, the last piece of legislation which addressed the issue of certain coins being allowed in individual retirement accounts and other individually directed pension plan accounts. In that instance, the menu of coins available for inclusion in these plans was expanded to allow platinum coins within the plans. As a result, today IRA investors can choose

¹²*Id.* at 609.

¹³GCM 39,043 (Aug. 5, 1983).

¹⁴Tech. Adv. Mem. 92-14-011 (April 3, 1992); Tech. Adv. Mem. 95-04-001 (January 27, 1995).

from a range of investment options in physical precious metals, in both coin and bar form.

As way of background, prior to 1981, all rare coins qualified as investments for self-directed retirement accounts. The Economic Recovery Tax Act of 1981 added section 408(m) to the U.S. Code, which created a category of "collectibles" that were no longer eligible for future investments in self-directed retirement accounts, such as Individual Retirement Accounts (IRAs). This category of collectibles included such things as wines, rugs, jewelry, antiques, and art. Arbitrarily, two long-tested and respected investments, rare coins, including investment grade U.S. legal tender coinage, and precious metals, were inappropriately included in this category, limiting investors' freedom of choice for investments.

The irony is that these coins are already allowed in corporate pension plans. The American investing public should not be penalized for not having access to corporate pension options. Because U.S. legal tender coin investments can be included in defined contribution pension and profit-sharing plans, it is only equitable to provide such investment options for self-directed retirement plans. Removing current restrictions would allow individual investors, whose total investment program (or much of it) consists of their IRAs or other self-directed accounts, to select from the same investment options currently available to corporate investors.

Such legislation simply expands the menu of options for investors and allows them to diversify and stabilize their retirement portfolios. Some investors are understandably nervous having all their investment "eggs" in a volatile stock market basket. Allowing tangible assets in an investment portfolio creates certain safeguards for the overall investment portfolio "basket." Indeed, as current stock portfolios are losing value, the certified coin market has been extremely active and coin values have been rising.

H.R. 1820 ensures that certified U.S. legal tender coins purchased for self-directed retirement accounts must be in the control of a qualified, third party trustee (as defined by the IRS), and not in the control of the investor. Also, coins eligible for inclusion in a self-directed retirement account must be certified by a recognized, independent third-party grading service, i.e., graded and encapsulated in a sealed plastic case. Each coin, therefore, has a unique identification number, grade, and description. Further, liquidity is assured by including as eligible only those coins that trade on recognized national electronic coin exchanges, or that are listed by a recognized wholesale reporting service.

The Joint Committee on Taxation has previously determined that the proposal to restore certified legal tender coins, as qualified investments will have negligible economic impact on federal revenues.

I am hopeful that H.R. 1820 can be included within H.R. 3654, and if I can provide further information or answer any questions, please feel free to call on me or contact Chris Stanley on my staff at 53015.

Sincerely,

The Honorable David Vitter
Member of Congress

