MEMORANDUM FOR TAX LAs

From: Senate Finance Committee Staff
Date: May 10, 2005
Subject: Revenue Offsets in SAFETEA

The Substitute Amendment, No. 605, offered by Chairman Inhofe to H.R. 3, the Safe, Accountable, Flexible, Efficient Transportation Equity Act of 2005 (SAFETEA) includes the Finance Committee title with the following revenue offsets:

A. Modify the tax treatment of contingent payment convertible debt instruments. The provision creates a consistent "apples to apples" approach to value contingent convertible debt for purposes of computing original issue discount (OID). A "comparable rate" for a contingent, *convertible* debt instrument would be based on a noncontingent, *convertible* debt instrument (and not a non-convertible debt instrument, as the IRS now applies the law). *Raises $462 million over ten years.*

B. Frivolous tax submissions. The provision increases the penalty for filing frivolous tax returns or for filing frivolous tax submissions from $500 to $5,000 and expands the penalty to apply to all taxpayers and all types of Federal taxes. This provision applies to submissions for collection due process, installment agreements, offers-in-compromise and taxpayer assistance orders. This provision becomes effective for all submissions and issues raised after the date on which the Secretary first prescribes the required list of frivolous positions. *Raises $30 million over ten years.*

C. Increased criminal fines and penalties. The provision increases criminal fines and prison sentences for the three most common offenses: failure to file, filing a false or fraudulent return and tax evasion. These proposed changes are substantially similar to increased criminal penalty provisions passed by the Senate in last year's JOBS Act. One notable change is the creation of a new aggravated failure to file offense. While retaining the current misdemeanor penalty for non-filers needed to address simple violations, the new provision creates an aggravated offense to address more serious noncompliant behavior ("aggravated" means failing to file for 3 or more years with an aggregate tax liability of $100,000 or more). *Raises $5 million over ten years.*

D. Doubled penalties for concealment of income using offshore accounts. The provision doubles penalties, interest and fines on taxpayers deliberately concealing taxable income by using offshore accounts, including credit cards. This provision applies to taxpayers who have an offshore account and have not signed a closing agreement in the IRS Offshore Voluntary Compliance Initiative (OVCI) or voluntarily disclosed participation in such arrangement to the IRS. This provision would become effective for taxpayers' open tax years on or after date of enactment. *Raises $10 million over ten years.*

E. Modification of CFC-PFIC coordination rules. The provision limits the exception from passive foreign investment company (PFIC) rules for United States shareholders of controlled foreign corporations (CFC). Current law may enable a U.S. shareholder to claim exemption from the PFIC rules with respect to ownership of CFC stock on the basis of mere status as a U.S. shareholder, despite the fact that the U.S. shareholder may have implemented a structure intended to render it impossible for such shareholder to recognize any income under subpart F in connection with the stock. This provision would become effective for taxable years of foreign corporations beginning after March 2, 2005, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end. *Raises $119 million over ten years.*

F. Declaration by CEO relating to federal annual corporate income tax return of a corporation. The provision requires that the annual federal income tax return of a corporation contain a declaration signed by the chief executive officer under penalties of perjury. The declaration would confirm that the corporation has in place processes and procedures that ensure the return is compliant and that the CEO was provided reasonable assurance of the accuracy of all material aspects of the return. The provision is effective for Federal tax returns for taxable years ending after the date of enactment. *Negligible revenue effect.*

G. Grant Treasury regulatory authority to address foreign tax credit transactions. The provision authorizes the Secretary of the Treasury to promulgate regulations to address abusive foreign tax credit (FTC) schemes that involve the inappropriate separation or stripping of foreign taxes from the related foreign income so taxpayers get the benefit of the FTC but don't report the related income. The provision becomes effective for transactions entered into after the date of enactment. *Raises $16 million over ten years.*

H. Whistleblower reforms. This provision provides greater certainty and independent review for whistleblowers who are seeking a cash award for providing assistance to the IRS. The provision is focused on encouraging whistleblowers who provide information about corporations and wealthy individuals who have a significant unpaid tax liability. In addition, the provision creates a Whistleblower Office at the IRS that will be dedicated to working with whistleblowers who provide valuable information about tax violations. The IRS would be required to report annually to Congress on the program. The provision becomes effective for information provided after the date of enactment. *Raises $407 million over ten years.*

I. Denial of deduction for certain fines, penalties, and other amounts. This provision clarifies that amounts paid or incurred whether by suit, agreement or otherwise to, or at the direction of a government, in relation to a violation of any law or the governmental investigation or inquiry into the potential violation of any law are not deductible for Federal income tax purposes. The provision is effective for amounts paid or incurred on or after the date of enactment unless paid under a binding order or agreement entered before that date. *Raises $200 million over ten years.*

J. Freeze interest and suspension rules with respect to listed transactions (sec. 6404(g) modification). This provision is directed toward investors in abusive tax avoidance transactions that have been designated as "listed transactions" by the IRS. It eliminates the 18 month suspension of interest benefit that normally applies if the IRS does not notify the taxpayer of its tax liability within 18 months of the return due date. This provision becomes effective for transactions with open years on or after the date of enactment. *Raises $396 million over ten years.*

K. Repeal Section 470 exception for qualified transportation property (SILOs). The provision repeals an exceedingly generous transition rule permitting a leasing tax shelter abuse in the transportation sector called SILOs. SILO schemes allowed corporations to claim tax deductions for bridges, pipelines, and subways that are paid for with taxpayer dollars. Congress passed the American Jobs Creation Act last fall and outlawed SILOs, but under that bill, SILO shelter promoters received more than a year to get their deals-in-process approved by the Department of Transportation. This provision will repeal that transition relief and will end abusive SILO tax shelters as of the enactment date of the American Jobs Creation Act. *Raises $372 million over ten years.*

L. Impose Mark-to-Market on individuals who expatriate. The provision generally subjects certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who terminate their U.S. residence to tax on the net unrealized gain in their property as if such property were sold for fair market value on the day before the expatriation or residency termination. Gain from the deemed sale is taken into account at that time without regard to other tax code provisions; any loss from the deemed sale generally would be taken into account to the extent otherwise provided in the code. Any net gain on the deemed sale is recognized to the extent it exceeds $600,000 ($1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency). This provision becomes effective for U.S. citizens who expatriate or long-term residents who terminate their residency on or after the date of enactment. *Raises $493 million over ten years.*

M. Deny deduction for punitive damages. The provision eliminates the deduction for punitive damages that are paid or incurred by the taxpayer as a result of a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, any such punitive damages paid by the insurer are included in gross income of the insured person and the insurer is required to report such amounts to both the insured person and the IRS. The provision is effective for punitive damages that are paid or incurred on or after the date of enactment. *Raises $350 million over ten years.*

N. Application of earnings stripping rules to C corporations which are partners. Present law provides rules to limit the ability of U.S. subsidiaries of foreign corporations to reduce U.S. tax on their U.S.-source income through earnings-stripping transactions. The present law earnings-stripping provision does not apply to partnerships. Proposed Treasury regulations provide that a corporate partner's proportionate share of a partnership's liabilities is treated as debt of the corporation for purposes of applying the earnings-stripping limitation to the corporation's own interest payments. This provision

codifies a rule attributing partnership debt to the corporate partner for this earnings-stripping test. *Raises $298 million over ten years.*

O. Deferral of certain stock option and restricted stock option gains prohibited. This provision eliminates the ability of an executive to avoid or defer paying income tax on the value of stock options. Stock options transferred to a related party in exchange for deferred installment or lump sum payments are taxable to the executive in the year of the exchange with the related party. This provision becomes effective for any exchange on or after the date of enactment. *Raises $64 million over ten years.*

P. Clarification of the economic substance doctrine and related penalty provisions. This provision clarifies the application of the economic substance doctrine but does not change current law standards used by courts in determining when to utilize an economic substance analysis. The provision does not alter the court's ability to aggregate or disaggregate a transaction when applying the doctrine. The provision provides a uniform definition of economic substance, but does not alter court flexibility in other respects. This provision has been included in several Senate-passed bills. Specifically, in any case in which a court determines that the economic substance doctrine is relevant to a transaction, the economic substance doctrine would be satisfied only if (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose. The 20 percent penalty for transactions that lack economic substance is increased to 40 percent if the transaction is not disclosed to the IRS. This provision becomes effective for transactions entered into after the date of enactment. *Raises $15.9 billion over ten years.*

Q. Termination of installment agreements. This provision would terminate installment agreements for failure to file returns and failure to make tax deposits. Although a significant number of taxpayers violate the terms of their installment agreements by failing to timely file their tax returns or make required Federal tax deposits, the IRS is not permitted to terminate installment agreements for these reasons. This provision would be effective for failures occurring after the date of enactment. *Negligible revenue effect.*

R. Waiver of user fee for installment agreements using automated withdrawals. The IRS imposes a $43 user fee on taxpayers entering into an installment agreement. The provision would waive the user fee if the taxpayer agrees to automated withdrawal of installment payments from a bank account. This provision will help facilitate collection through automated withdrawals. *Costs $35 million over ten years.*

S. Offers-in-compromise. The provision requires that a taxpayer make a good faith down payment of 20 percent of any lump sum offer-in-compromise with any application for an offer. For periodic payment offers, the taxpayer is required to comply with their own payment schedule. The provision also repeals the $150 user fee, eliminates Chief Counsel review of certain offers, reduces the IRS time to accept an offer from 24 months

to 12 months beginning in 2010, and creates a task force to review the entire OIC program and make recommendations. *Raises $668 million over ten years.*

T. Additional Revenue Provisions to Combat Fuel Fraud

1. Allow credit card companies to claim refunds for gas purchased by exempt users with fuel credit cards. This provision requires credit card companies who allow tax-exempt fuel purchases on their credit cards to register with the IRS and to be the party responsible for claiming refunds of the tax. This provision becomes effective for sales after the 12/31/05. *Negligible revenue effect.*

2. Additional requirements for exempt purchases. States, local governments and schools can purchase tax-exempt fuel. It is difficult for vendors to know whether some entities are in fact entitled to the exemption. The provision requires the states to certify whether an entity is part of the state or a local government. In addition, the provision clarifies the rule that it is schools that are exempt from fuel taxes and not all non-profit educational organizations, like trade associations. *Raises $43 million over ten years.*

3. Repeal of ultimate vendor claims with respect to farming. One area where IRS continues to see fuel tax evasion is the misuse of exempt fuel intended for farming purposes. The provision requires farmers who buy clear diesel to buy it tax paid. They can claim a refund for amounts used for farming purposes. Farmers may continue to buy tax free diesel if it is dyed. *Raises less than $500,000 over ten years.*

4. Coordinate Homeland Security information reporting with IRS reporting. Requires Department of Homeland Security and Treasury to provide for the transmission to the IRS of information pertaining to taxable fuels destined for importation into the U.S. *Raises $41 million over ten years.*

5. Require registration of large draft vessels. Present law requires registration of vessels (ships and barges) for tax-exempt bulk transfers of fuel. Treasury regulations have created an exemption for large draft vessels. The provision overturns the regulation. *Raises $31 million over ten years.*

6. Taxation of gasoline blendstocks and kerosene. The provision taxes gasoline blendstocks when they are removed from the bulk system. This will prevent untaxed blendstocks from being blended with taxed fuel. In addition, present law taxes kerosene, but Treasury regulations have exempted some kerosene. The provision partially overturns that regulation. *Raises $1.18 billion over ten years.*

7. Duty free gas. A retail fuel station continues to challenge IRS and Customs determinations that fuel may not be sold tax free at duty free zones. The provision clarifies that fuel purchased and placed into the fuel tank of a vehicle is not purchased for export. This will prevent the sale of gasoline tax free in duty free zones near the U.S. border. *No revenue effect.*

8. Removals of kerosene from terminals. Kerosene can be used as diesel or aviation fuel. The provision will tax all removals of kerosene other than into the wing of an airplane as diesel (24.4 cents per gallon). All receipts would go to the Highway Trust Fund. If the fuel is eventually used for aviation purposes a refund will be available to bring the tax down to the appropriate aviation fuel rate. The HTF will pay to the Airport and Airway Trust Fund the appropriate amount of tax paid on fuel used for aviation purposes. *Raises $495 million over ten years.*

9. Penalty for adulterated fuel. Compliance officers routinely find that diesel is being sold for highway use with sulfur content well above 500 ppm. This suggests that untaxed, non-compliant diesel is being blended with taxed fuel. The provision imposes a $10,000 penalty for anyone who knowingly sells diesel that does not comply with EPA low sulfur diesel regulations. *Negligible revenue effect.*