

lated FSCs from property acquired by the FSCs from the corporation.⁶ However, this aggregate amount does not include any amount attributable to a transaction involving a lease by the corporation unless the corporation manufactured or produced (in whole or in part) the leased property.

The specified percentage to be used in determining the deduction is: 80 percent for calendar years 2004 and 2005; 60 percent for calendar year 2006; and 0 percent for calendar years 2007 and thereafter. For calendar year 2003, the specified percentage is the amount that bears the same ratio to 100 percent as the number of days after the date of enactment of this provision bears to 365. In the case of a corporation with a taxable year that is not the calendar year (i.e., a fiscal year corporation), a special rule is provided for determining a weighted average specified percentage based upon the calendar years that are included in the taxable year.

The deduction for a taxable year generally is reduced by the specified percentage of exempted FSC income and excluded extraterritorial income of the corporation for the taxable year from transactions pursuant to a binding contract.

Effective date.—The provision is effective for transactions occurring after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement follows the House bill, except that under the conference agreement the ETI exclusion provisions remain in effect for transactions in the ordinary course of a trade or business if such transactions are pursuant to a binding contract⁷ between the taxpayer and an unrelated person and such contract is in effect on September 17, 2003, and at all times thereafter.

Effective date.—The effective date is the same as the House bill.

B. DEDUCTION RELATING TO INCOME ATTRIBUTABLE TO UNITED STATES PRODUCTION ACTIVITIES

(Sec. 102 of the House bill, secs. 102 and 103 of the Senate amendment, and sec. 11 of the Code)

PRESENT LAW

A corporation's regular income tax liability is determined by applying the following tax rate schedule to its taxable income.

TABLE 1.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2004

Taxable income:	Income tax rate:
\$0–\$50,000	15 percent of taxable income.
\$50,001–\$75,000	25 percent of taxable income.
\$75,001–\$10,000,000	34 percent of taxable income.

⁶In the case of a short taxable year that ends after the date of enactment and begins before January 1, 2007, the Treasury Secretary shall prescribe guidance for determining the amount of the deduction, including guidance that limits the amount of the deduction for a short taxable year based upon the proportion that the number of days in the short taxable year bears to 365.

⁷This rule also applies to a purchase option, renewal option, or replacement option that is included in such contract. For this purpose, a replacement option will be considered enforceable against a lessor notwithstanding the fact that a lessor retained approval of the replacement lessee.

TABLE 1.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2004—Continued

Taxable income:	Income tax rate:
Over \$10,000,000	35 percent of taxable income.

The benefit of the first two graduated rates described above is phased out by a five-percent surcharge for corporations with taxable income between \$100,000 and \$335,000. Also, the benefit of the 34-percent rate is phased out by a three-percent surcharge for corporations with taxable income between \$15 million and \$18,333,333; a corporation with taxable income of \$18,333,333 or more effectively is subject to a flat rate of 35 percent.

Under present law, there is no provision that reduces the corporate income tax for taxable income attributable to domestic production activities.

HOUSE BILL

In general

The House bill provides that the corporate tax rate applicable to qualified production activities income may not exceed 32 percent (34 percent for taxable years beginning before 2007) of the qualified production activities income.

Qualified production activities income

“Qualified production activities income” is the income attributable to domestic production gross receipts, reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts; (2) other deductions, expenses, or losses that are directly allocable to such receipts; and (3) a proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.⁸

DOMESTIC PRODUCTION GROSS RECEIPTS

Under the House bill, “domestic production gross receipts” generally are gross receipts of a corporation that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property that was manufactured, produced, grown or extracted (in whole or in significant part) by the corporation within the United States;⁹ (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film produced by the taxpayer; or (3) construction, engineering or architectural services performed in the United States for construction projects located in the United States. However, domestic production

⁸The House bill provides that Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to domestic production activities. Where appropriate, such rules shall be similar to and consistent with relevant present-law rules (e.g., secs. 263A and 861).

⁹Domestic production gross receipts under the House bill include gross receipts of a taxpayer derived from any sale, exchange or other disposition of agricultural products with respect to which the taxpayer performs storage, handling or other processing activities (other than transportation activities) within the United States, provided such products are consumed in connection with, or incorporated into, the manufacturing, production, growth or extraction of qualifying production property (whether or not by the taxpayer). Domestic production gross receipts also include gross receipts of a taxpayer derived from any sale, exchange or other disposition of food products with respect to which the taxpayer performs processing activities (in whole or in significant part) within the United States.

gross receipts do not include any gross receipts of the taxpayer derived from property that is leased, licensed or rented by the taxpayer for use by any related person.¹⁰

“Qualifying production property” under the House bill generally is any tangible personal property, computer software, or property described in section 168(f)(4) of the Code. “Qualified film” is any property described in section 168(f)(3) of the Code (other than certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of such film (other than compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

Under the House bill, an election under section 631(a) made by a corporate taxpayer for a taxable year ending on or before the date of enactment to treat the cutting of timber as a sale or exchange, may be revoked by the taxpayer without the consent of the IRS for any taxable year ending after that date. The prior election (and revocation) is disregarded for purposes of making a subsequent election.

Effective date.—The House bill provision is effective for taxable years beginning after December 31, 2004.

SENATE AMENDMENT

In general

The Senate amendment provides a deduction equal to a portion of the taxpayer’s qualified production activities income. For taxable years beginning after 2008, the Senate amendment deduction is nine percent of such income. For taxable years beginning in 2004, 2005, 2006, 2007 and 2008, the deduction is five, five, five, six, and seven percent of income, respectively. However, the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer during such taxable year.¹¹ In the case of corporate taxpayers that are members of certain affiliated groups, the deduction is determined by treating all members of such groups as a single taxpayer.

¹⁰It is intended under the House bill that principles similar to those under the present-law extraterritorial income regime apply for this purpose. See Temp. Treas. Reg. sec. 1.927(a)-1T(f)(2)(i). For example, this exclusion generally does not apply to property leased by the taxpayer to a related person if the property is held for sublease, or is subleased, by the related person to an unrelated person for the ultimate use of such unrelated person. Similarly, the license of computer software to a related person for reproduction and sale, exchange, lease, rental or sublicense to an unrelated person for the ultimate use of such unrelated person is not treated as excluded property by reason of the license to the related person.

¹¹For purposes of the Senate amendment, “wages” include the sum of the aggregate amounts of wages (as defined in section 3401(a) without regard to exclusions for remuneration paid for services performed in possessions of the United States) and elective deferrals that the taxpayer is required to include on statements with respect to the employment of employees of the taxpayer during the taxpayer’s taxable year. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and, for taxable years beginning after December 31, 2005, designated Roth contributions (as defined in section 402A). Any wages taken into account for purposes of determining the wage limitation under the Senate amendment cannot also be taken into account for purposes of determining any credit allowable under sections 30A or 936.

Qualified production activities income

In general, “qualified production activities income” under the Senate amendment is the modified taxable income¹² of a taxpayer that is attributable to domestic production activities. Income attributable to domestic production activities generally is equal to domestic production gross receipts, reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts;¹³ (2) other deductions, expenses, or losses that are directly allocable to such receipts; and (3) a proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.¹⁴

For taxable years beginning before 2013, the Senate amendment provides that qualified production activities income is reduced by virtue of a fraction (not to exceed one), the numerator of which is the value of the domestic production of the taxpayer and the denominator of which is the value of the worldwide production of the taxpayer (the “domestic/worldwide fraction”).¹⁵ For taxable years beginning in 2010, 2011, and 2012, the reduction in qualified production activities income by virtue of this fraction is reduced by 25, 50, and 75 percent, respectively. For taxable years beginning after 2012, there is no reduction in qualified production activities income by virtue of this fraction.

Domestic production gross receipts

Under the Senate amendment, “domestic production gross receipts” are gross receipts of a taxpayer that are derived in the actual conduct of a trade or business from any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property that was manufactured, produced, grown or extracted (in whole or in significant part) by the taxpayer within the United States or any possession of the United States.¹⁶ Such term

¹²“Modified taxable income” under the Senate amendment is taxable income of the taxpayer computed without regard to the deduction provided by the Senate amendment. Qualified production activities income is limited to the modified taxable income of the taxpayer.

¹³For purposes of determining such costs under the Senate amendment, any item or service that is imported into the United States without an arm’s length transfer price shall be treated as acquired by purchase, and its cost shall be treated as not less than its fair market value when it entered the United States. A similar rule shall apply in determining the adjusted basis of leased or rented property where the lease or rental gives rise to domestic production gross receipts. With regard to property previously exported by the taxpayer for further manufacture, the increase in cost or adjusted basis shall not exceed the difference between the fair market value of the property when exported and the fair market value of the property when re-imported into the United States after further manufacture.

¹⁴The Senate amendment provides that the Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to domestic production activities. Where appropriate, such rules shall be similar to and consistent with relevant present-law rules (e.g., secs. 263A and 861).

¹⁵For purposes of the domestic/worldwide fraction under the Senate amendment, the value of domestic production is the excess of domestic production gross receipts (as defined below) over the cost of deductible purchased inputs that are allocable to such receipts. Similarly, the value of worldwide production is the excess of worldwide production gross receipts over the cost of deductible purchased inputs that are allocable to such receipts. For purposes of determining the domestic/worldwide fraction, purchased inputs include: purchased services (other than employees) used in manufacture, production, growth, or extraction activities; purchased items consumed in connection with such activities; and purchased items incorporated as part of the property being manufactured, produced, grown, or extracted. In the case of corporate taxpayers that are members of certain affiliated groups, the domestic/worldwide fraction is determined by treating all members of such groups as a single taxpayer.

¹⁶Under the Senate amendment, domestic production gross receipts include gross receipts of a taxpayer derived from any sale, exchange or other disposition of agricultural products with respect to which the taxpayer performs storage, handling or other processing activities (but not

Continued

also includes a percentage of gross receipts derived from engineering or architectural services performed in the United States for construction projects in the United States.¹⁷ Finally, such term includes gross receipts derived by the taxpayer from the use of film and videotape property produced in whole or in significant part by the taxpayer within the United States. “Qualifying production property” generally is any tangible personal property, computer software, or property described in section 168(f)(3) or (4) of the Code.¹⁸ However, qualifying production property does not include: (1) consumable property that is sold, leased or licensed as an integral part of the provision of services; (2) oil or gas (other than certain primary products thereof);¹⁹ (3) electricity; (4) water supplied by pipeline to the consumer; (5) utility services; and (6) any film, tape, recording, book, magazine, newspaper or similar property the market for which is primarily topical or otherwise essentially transitory in nature.²⁰

Other rules

Qualified production activities income of passthrough entities (other than cooperatives)

With respect to domestic production activities of an S corporation, partnership, estate, trust or other passthrough entity (other than an agricultural or horticultural cooperative), the deduction under the Senate amendment generally is determined at the shareholder, partner or similar level by taking into account at such level the proportionate share of qualified production activities income of the entity.²¹ The Senate amendment directs the Secretary to prescribe rules for the application of the deduction to passthrough entities, including reporting requirements and rules relating to restrictions on the allocation of the deduction to taxpayers at the partner or similar level.

transportation activities) within the United States, provided such products are consumed in connection with, or incorporated into, the manufacturing, production, growth or extraction of qualifying production property (whether or not by the taxpayer).

¹⁷For taxable years beginning in 2004 through 2008, the applicable percentage is 25%. For taxable years beginning in 2009 through 2012, the applicable percentage is 50%. For taxable years beginning after 2012, the applicable percentage is 100%.

¹⁸For purposes of the definition of qualified production property under the Senate amendment, property described in section 168(f)(3) or (4) of the Code includes underlying copyrights and trademarks. In addition, gross receipts from the sale, exchange, lease, rental, license or other disposition of property described in section 168(f)(3) or (4) are treated as domestic production gross receipts if more than 50 percent of the aggregate development and production costs of such property are incurred by the taxpayer within the United States. For this purpose, property that is acquired by the taxpayer after development or production has commenced, but before such property generates substantial gross receipts, shall be treated as developed or produced by the taxpayer.

¹⁹Under the Senate amendment, qualifying production property does not include extracted but unrefined oil or gas, but generally includes primary products of oil and gas that are produced by the taxpayer. Examples of primary products for this purpose include motor fuels, chemical feedstocks and fertilizer. However, primary products do not include the output of a natural gas processing plant. Natural gas processing plants generally are located at or near the producing gas field that supplies the facility, and the facility serves to separate impurities from the natural gas liquids recovered from the field for the purpose of selling the liquids for future production and preparation of the natural gas for pipeline transportation.

²⁰The topical and transitory exclusion does not apply to the extent of the gross receipts from the use of film and videotape property produced in whole or in significant part by the taxpayer within the United States.

²¹However, the wage limitation described above is determined at the entity level in computing the deduction with respect to qualified production activities income of a passthrough entity.

Qualified production activities income of agricultural and horticultural cooperatives

With regard to member-owned agricultural and horticultural cooperatives formed under Subchapter T of the Code, the Senate amendment provides the same treatment of qualified production activities income derived from products marketed through cooperatives as it provides for qualified production activities income of other taxpayers (i.e., the cooperative may claim a deduction from qualified production activities income). In addition, the Senate amendment provides that the amount of any patronage dividends or per-unit retain allocations paid to a member of an agricultural or horticultural cooperative (to which Part I of Subchapter T applies), which is allocable to the portion of qualified production activities income of the cooperative that is deductible under the Senate amendment, is excludible from the gross income of the member. In order to qualify, such amount must be designated by the organization as allocable to the deductible portion of qualified production activities income in a written notice mailed to its patrons not later than the payment period described in section 1382(d). The cooperative cannot reduce its income under section 1382 (e.g., cannot claim a dividends-paid deduction) for such amounts.

Separate application to films and videotape

Under the Senate amendment, the deduction provided by this provision with respect to films and videotape is determined separately with respect to qualified production activities income of the taxpayer allocable to each of three markets: theatrical, broadcast television, and home video. The Senate amendment provides rules for making a separate determination of qualified production activities allocable to each market.

Alternative minimum tax

The deduction provided by the Senate amendment is allowed for purposes of the alternative minimum tax (including adjusted current earnings). The deduction is determined by reference to modified alternative minimum taxable income.

Coordination with ETI repeal

For purposes of the Senate amendment, domestic production gross receipts does not include gross receipts from any transaction that produces excluded extraterritorial income pursuant to the binding contract exception to the ETI repeal provisions of the Senate amendment.

Qualified production activities income is determined without regard to any deduction provided by the ETI repeal provisions of the Senate amendment.

Effective date.—The Senate amendment provision is effective for taxable years ending after the date of enactment.

CONFERENCE AGREEMENT

In general

The conference agreement provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that

is equal to a portion of the taxpayer's qualified production activities income. For taxable years beginning after 2009, the deduction is equal to nine percent of the lesser of (1) the qualified production activities income of the taxpayer for the taxable year, or (2) taxable income (determined without regard to this provision) for the taxable year. For taxable years beginning in 2005 and 2006, the deduction is three percent of income and, for taxable years beginning in 2007, 2008 and 2009, the deduction is six percent of income. However, the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer during the calendar year that ends in such taxable year.²² In the case of corporate taxpayers that are members of certain affiliated groups, the deduction is determined by treating all members of such groups as a single taxpayer and the deduction is allocated among such members in proportion to each member's respective amount (if any) of qualified production activities income.

Qualified production activities income

In general, "qualified production activities income" is equal to domestic production gross receipts, reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts;²³ (2) other deductions, expenses, or losses that are directly allocable to such receipts; and (3) a proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income.²⁴

Domestic production gross receipts

"Domestic production gross receipts" generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States;²⁵ (2) any sale, exchange or other disposition, or any

²²For purposes of the conference agreement, "wages" include the sum of the aggregate amounts of wages and elective deferrals that the taxpayer is required to include on statements with respect to the employment of employees of the taxpayer during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and, for taxable years beginning after December 31, 2005, designated Roth contributions (as defined in section 402A).

²³For purposes of determining such costs, any item or service that is imported into the United States without an arm's length transfer price shall be treated as acquired by purchase, and its cost shall be treated as not less than its value when it entered the United States. A similar rule shall apply in determining the adjusted basis of leased or rented property where the lease or rental gives rise to domestic production gross receipts. With regard to property previously exported by the taxpayer for further manufacture, the increase in cost or adjusted basis shall not exceed the difference between the value of the property when exported and the value of the property when re-imported into the United States after further manufacture. Except as provided by the Secretary, the value of property for this purpose shall be its customs value (as defined in section 1059A(b)(1)).

²⁴The Secretary shall prescribe rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining income attributable to domestic production activities. Where appropriate, such rules shall be similar to and consistent with relevant present-law rules (e.g., sec. 263A, in determining the cost of goods sold, and sec. 861, in determining the source of such items). Other deductions, expenses or losses that are directly allocable to such receipts include, for example, selling and marketing expenses. A proper share of other deductions, expenses, and losses that are not directly allocable to such receipts or another class of income include, for example, general and administrative expenses allocable to selling and marketing expenses.

²⁵Domestic production gross receipts include gross receipts of a taxpayer derived from any sale, exchange or other disposition of agricultural products with respect to which the taxpayer performs storage, handling or other processing activities (other than transportation activities) within the United States, provided such products are consumed in connection with, or incor-

lease, rental or license, of qualified film produced by the taxpayer; (3) any sale, exchange or other disposition electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction activities performed in the United States;²⁶ or (5) engineering or architectural services performed in the United States for construction projects located in the United States.

However, domestic production gross receipts do not include any gross receipts of the taxpayer that are derived from (1) the sale of food or beverages prepared by the taxpayer at a retail establishment,²⁷ or (2) the transmission or distribution of electricity, natural gas, or potable water.²⁸ In addition, domestic production gross re-

ported into, the manufacturing, production, growth or extraction of qualifying production property (whether or not by the taxpayer).

²⁶For this purpose, construction activities include activities that are directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure. Substantial renovation would include structural improvements, but not mere cosmetic changes, such as painting.

²⁷The conferees intend that food processing, which generally is a qualified production activity under the conference agreement, does not include activities carried out at retail establishment. Thus, under the conference agreement while the gross receipts of a meat packing establishment are qualified domestic production gross receipts, the activities of a master chef who creates a venison sausage for his or her restaurant menu cannot be construed as a qualified production activity.

The conferees recognize that some taxpayers may own facilities at which the predominant activity is domestic production as defined in the conference agreement and other facilities at which they engage in the retail sale of the taxpayer's produced goods and also sell food and beverages. For example, assume that the taxpayer buys coffee beans and roasts those beans at a facility, the primary activity of which is the roasting and packaging of roasted coffee. The taxpayer sells the roasted coffee through a variety of unrelated third-party vendors and also sells roasted coffee at the taxpayer's own retail establishments. In addition, at the taxpayer's retail establishments, the taxpayer prepares brewed coffee and other foods. The conferees intend that to the extent that the gross receipts of the taxpayer's retail establishment represent receipts from the sale of its roasted coffee beans to customers, the receipts are qualified domestic production gross receipts, but to the extent that the gross receipts of the taxpayer's retail establishment represent receipts from the sale of brewed coffee or food prepared at the retail establishment, the receipts are not qualified domestic production gross receipts. However, the conferees intend that, in this case, the taxpayer may allocate part of the receipts from the sale of the brewed coffee as qualified domestic production gross receipts to the extent of the value of the roasted coffee beans used to brew the coffee. The conferees intend that the Secretary provide guidance drawing on the principles of section 482 by which such a taxpayer can allocate gross receipts between qualified and nonqualified gross receipts. The conferees observe that in this example, the taxpayer's sales of roasted coffee beans to unrelated third parties would provide a value for the beans used in brewing a cup of coffee for retail sale.

The conferees intend that the disqualification of gross receipts derived from the sale of food and beverage prepared by the taxpayer at a retail establishment not be construed narrowly to apply only to establishments at which customers dine on premises. The receipts of a facility that prepares food and beverage solely for take out service would not be qualified production gross receipts. Likewise, the conferees intend that the disqualification of gross receipts derived from the sale of food and beverages prepared by the taxpayer need not be limited to retail establishments primarily engaged in the dining trade. For example, if a taxpayer operates a supermarket and as part of the supermarket the taxpayer operates an in-store bakery, the same allocation described above would apply to determine the extent to which the taxpayer's gross receipts represent qualified domestic production gross receipts.

²⁸The conference agreement provides that domestic production gross receipts include the gross receipts from the production in the United States of electricity, gas, and potable water, but excludes the gross receipts from the transmission or distribution of electricity, gas, and potable water. Thus, in the case of a taxpayer who owns a facility for the production of electricity, whether the taxpayer's facility is part of a regulated utility or an independent power facility, the taxpayer's gross receipts from the production of electricity at that facility are qualified domestic production gross receipts. However, to the extent that the taxpayer is an integrated producer that generates electricity and delivers electricity to end users, any gross receipts properly attributable to the transmission of electricity from the generating facility to a point of local distribution and any gross receipts properly attributable to the distribution of electricity to final customers are not qualified domestic production gross receipts. For example, assume taxpayer A owns a wind turbine that generates electricity and taxpayer B owns a high-voltage transmission line that passes near taxpayer A's wind turbine and ends near the system of local distribution lines of taxpayer C. Taxpayer A sells the electricity produced at the wind turbine to taxpayer C and contracts with taxpayer B to transmit the electricity produced at the wind turbine to taxpayer C who sells the electricity to his or her customers using taxpayer C's distribution network. The gross receipts received by taxpayer A for the sale of electricity produced at

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ceipts do not include any gross receipts of the taxpayer derived from property that is leased, licensed or rented by the taxpayer for use by any related person.²⁹

“Qualifying production property” generally includes any tangible personal property, computer software, or sound recordings. “Qualified film” includes any motion picture film or videotape³⁰ (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of such film (including compensation in the form of residuals and participations³¹) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.³²

Other rules

Qualified production activities income of passthrough entities (other than cooperatives)

With respect to domestic production activities of an S corporation, partnership, estate, trust or other passthrough entity (other than an agricultural or horticultural cooperative), although the wage limitation is applied first at the entity level, the deduction under the conference agreement generally is determined at the shareholder, partner or similar level by taking into account at such level the proportionate share of qualified production activities in-

the wind turbine constitute qualifying domestic production gross receipts. The gross receipts of taxpayer B from transporting taxpayer A's electricity to taxpayer C are not qualifying domestic production gross receipts. Likewise the gross receipts of taxpayer C from distributing the electricity are not qualifying domestic production gross receipts. Also, if taxpayer A made direct sales of electricity to customers in taxpayer C's service area and taxpayer C receives remuneration for the distribution of electricity, the gross receipts of taxpayer C are not qualifying domestic production gross receipts. If taxpayers A, B, and C are all related taxpayer, then taxpayers A, B, and C must allocate gross receipts to production activities, transmission activities, and distribution activities in a manner consistent with the preceding example.

The conference agreement provides that the same principles apply in the case of the natural gas and water supply industries. In the case of natural gas, production activities generally are all activities involved in extracting natural gas from the ground and processing the gas into pipeline quality gas. Such activities would produce qualifying domestic production gross receipts. However gross receipts of a taxpayer attributable to transmission of pipeline quality gas from a natural gas field (or from a natural gas processing plant) to a local distribution company's citygate (or to another customer) are not qualified domestic production gross receipts. Likewise gas purchased by a local gas distribution company and distributed from the citygate to the local customers does not give rise to domestic production gross receipts.

In the case of the production of potable water the conferees intend that activities involved in the production of potable water include the acquisition, collection, and storage of raw water (untreated water). It also includes the transportation of raw water to a water treatment facility and treatment of raw water at such a facility. However, any gross receipts from the storage of potable water after the water treatment facility or delivery of potable water to customers does not give rise to qualifying domestic production gross receipts. The conferees intend that a taxpayer that both produces potable water and distributes potable water will properly allocate gross receipts across qualifying and non-qualifying activities.

²⁹It is intended that principles similar to those under the present-law extraterritorial income regime apply for this purpose. See Temp. Treas. Reg. sec. 1.927(a)-1T(f)(2)(i). For example, this exclusion generally does not apply to property leased by the taxpayer to a related person if the property is held for sublease, or is subleased, by the related person to an unrelated person for the ultimate use of such unrelated person. Similarly, the license of computer software to a related person for reproduction and sale, exchange, lease, rental or sublicense to an unrelated person for the ultimate use of such unrelated person is not treated as excluded property by reason of the license to the related person.

³⁰The conferees intend that the nature of the material on which properties described in section 168(f)(3) are embodied and the methods and means of distribution of such properties shall not affect their qualification under this provision.

³¹To the extent that a taxpayer has included an estimate of participations and/or residuals in its income forecast calculation under section 167(g), such taxpayer must use the same estimate of participations and/or residuals for purposes of determining total compensation.

³²It is intended that the Secretary will provide appropriate rules governing the determination of total compensation for services performed in the United States.

come of the entity. The Secretary is directed to prescribe rules for the application of the conference agreement to passthrough entities, including reporting requirements and rules relating to restrictions on the allocation of the deduction to taxpayers at the partner or similar level.

For purposes of applying the wage limitation at the level of a shareholder, partner, or similar person, each person who is allocated qualified production activities income from a passthrough entity also is treated as having been allocated wages from such entity in an amount that is equal to the lesser of: (1) such person's allocable share of wages, as determined under regulations prescribed by the Secretary; or (2) twice the appropriate deductible percentage of qualified production activities income that actually is allocated to such person for the taxable year.

Qualified production activities income of agricultural and horticultural cooperatives

With regard to member-owned agricultural and horticultural cooperatives formed under Subchapter T of the Code, the conference agreement provides the same treatment of qualified production activities income derived from agricultural or horticultural products that are manufactured, produced, grown, or extracted by cooperatives,³³ or that are marketed through cooperatives, as it provides for qualified production activities income of other taxpayers (i.e., the cooperative may claim a deduction from qualified production activities income).

In addition, the conference agreement provides that the amount of any patronage dividends or per-unit retain allocations paid to a member of an agricultural or horticultural cooperative (to which Part I of Subchapter T applies), which is allocable to the portion of qualified production activities income of the cooperative that is deductible under the conference agreement, is deductible from the gross income of the member. In order to qualify, such amount must be designated by the organization as allocable to the deductible portion of qualified production activities income in a written notice mailed to its patrons not later than the payment period described in section 1382(d). The cooperative cannot reduce its income under section 1382 (e.g., cannot claim a dividends-paid deduction) for such amounts.

Alternative minimum tax

The deduction provided by the conference agreement is allowed for purposes of computing alternative minimum taxable income (including adjusted current earnings). The deduction in computing alternative minimum taxable income is determined by reference to the lesser of the qualified production activities income (as determined for the regular tax) or the alternative minimum taxable income (in the case of an individual, adjusted gross income as determined for the regular tax) without regard to this deduction.

³³For this purpose, agricultural or horticultural products also include fertilizer, diesel fuel and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the cooperative.

Timber cutting

Under the conference agreement, an election made for a taxable year ending on or before the date of enactment, to treat the cutting of timber as a sale or exchange, may be revoked by the taxpayer without the consent of the IRS for any taxable year ending after that date. The prior election (and revocation) is disregarded for purposes of making a subsequent election.

Exploration of fundamental tax reform

The conferees acknowledge that Congress has not reduced the statutory corporate income tax rate since 1986. According to the Organisation of Economic Cooperation and Development (“OECD”), the combined corporate income tax rate, as defined by the OECD, in most instances is lower than the U.S. corporate income tax rate.³⁴ Higher corporate tax rates factor into the United States’ ability to attract and retain economically vibrant industries, which create good jobs and contribute to overall economic growth.

This legislation was crafted to repeal an export tax benefit that was deemed inconsistent with obligations of the United States under the Agreement on Subsidies and Countervailing Measures and other international trade agreements. This legislation replaces the benefit with tax relief specifically designed to be economically equivalent to a 3-percentage point reduction in U.S.-based manufacturing.

The conferees recognize that manufacturers are a segment of the economy that has faced significant challenges during the nation’s recent economic slowdown. The conferees recognize that trading partners of the United States retain subsidies for domestic manufacturers and exports through their indirect tax systems. The conferees are concerned about the adverse competitive impact of these subsidies on U.S. manufacturers.

These concerns should be considered in the context of the benefits of a unified top tax rate for all corporate taxpayers, including manufacturing, in terms of efficiency and fairness. The conferees also expect that the tax-writing committees will explore a unified top corporate tax rate in the context of fundamental tax reform.

Effective date.—The conference agreement is effective for taxable years beginning after December 31, 2004.

C. REDUCED CORPORATE INCOME TAX RATE FOR SMALL
CORPORATIONS

(Sec. 103 of the House bill and sec. 11 of the Code)

PRESENT LAW

A corporation’s regular income tax liability is determined by applying the following tax rate schedule to its taxable income.

TABLE 1.—MARGINAL FEDERAL CORPORATE INCOME TAX RATES FOR 2004

Taxable income:	Income tax rate:
\$0–\$50,000	15 percent of taxable income.

³⁴ Organisation of Economic Cooperation and Development, Table 1.5, Tax Data Base Statistics, Tax Policy and Administration, Summary Tables (2003).