

(ii) the taxpayer and members of the taxpayer's family.

(ii) any corporation (including an S corporation) if 50 percent or more (in value) of the stock of such corporation is owned (directly or through the application of section 318) by the taxpayer or members of the taxpayer's family,

(iii) a corporation and any other corporation which is a member of the same controlled group described in section 1563(a)(1), and

(iv) any partnership if 50 percent or more (in value) of the interests in such partnership is owned directly or indirectly by the taxpayer or members of the taxpayer's family.

(C) Members of family. -- For purposes of this paragraph, the term "family" means the taxpayer, the spouse of the taxpayer, and any of their children who have not attained age 18 before the close of the taxable year.

(3) Preproductive period. --

(A) In general. -- For purposes of this section, the term "preproductive period" means --

(i) in the case of a plant or animal which will have more than 1 crop or yield, the period before the 1st marketable crop or yield from such plant, or

(ii) in the case of any other plant, the period before such plant is reasonably expected to be disposed of.

For purposes of this subparagraph, use by the taxpayer in a farming business of any supply produced in such business shall be treated as a disposition.

(B) Rule for determining period. -- In the case of a plant grown in commercial quantities in the United States, the preproductive period for such plant if grown in the United States shall be based on the nationwide weighted average preproductive period for such plant.

(4) Farming business. -- For purposes of this section --

(A) In general. -- The term "farming business" means the trade or business of farming.

(B) Certain trades and businesses included. -- The term "farming business" shall include the trade or business of --

(i) operating a nursery or sod farm, or

(ii) the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees.

For purposes of clause (ii), an evergreen tree which is more than 6 years old at the time severed from the roots shall not be treated as an ornamental tree.

(5) Certain inventory valuation methods permitted. -- The Secretary shall by regulations permit the taxpayer to use reasonable inventory valuation methods to compute the amount required to be capitalized under subsection (a) in the case of any plant

(f) Special rules for allocation of interest to property produced by the taxpayer. --

(1) Interest capitalized only in certain cases. -- Subsection (a) shall only apply to interest costs which are --

(A) paid or incurred during the production period, and

(B) allocable to property which is described in subsection (b)(1) and which has --

(i) a long useful life,

(ii) an estimated production period exceeding 2 years, or

(iii) an estimated production period exceeding 1 year and a cost exceeding \$1,000,000.

(2) Allocation rules. --

(A) In general. -- In determining the amount of interest required to be capitalized under subsection (a) with respect to any property --

(i) interest on any indebtedness directly attributable to production expenditures with

respect to such property shall be assigned to such property, and

(ii) interest on any other indebtedness shall be assigned to such property to the extent that the taxpayer's interest costs could have been reduced if production expenditures (not attributable to indebtedness described in clause (i)) had not been incurred.

(B) Exception for qualified residence interest. -- Subparagraph (A) shall not apply to any qualified residence interest (within the meaning of section 163(h)).

(C) Special rule for flow-through entities. -- Except as provided in regulations, in the case of any flow-through entity, this paragraph shall be applied first at the entity level and then at the beneficiary level.

(3) Interest relating to property used to produce property. -- This subsection shall apply to any interest on indebtedness allocable (as determined under paragraph (2)) to property used to produce property to which this subsection applies to the extent such interest is allocable (as so determined) to the produced property.

(4) Definitions. -- For purposes of this subsection --

(A) Long useful life. -- Property has a long useful life if such property is --

(i) real property, or

(ii) property with a class life of 20 years or more (as determined under section 168).

(B) Production period. -- The term "production period" means, when used with respect to any property, the period --

(i) beginning on the date on which production of the property begins, and

(ii) ending on the date on which the property is ready to be placed in service or is ready to be held for sale.

(C) Production expenditures. -- The term "production expenditures" means the costs (whether or not incurred during the production period) required to be capitalized under subsection (a) with respect to the property.

(g) Production. -- For purposes of this section --

(1) In general. -- the term "produce" includes construct, build, install, manufacture, develop, or improve.

(2) Treatment of property produced under contract for the taxpayer. -- The taxpayer shall be treated as producing any property produced for the taxpayer under a contract with the taxpayer; except that only costs paid or incurred by the taxpayer (whether under such contract or otherwise) shall be taken into account in applying subsection (a) to the taxpayer.

(h) Exemption for free lance authors, photographers, and artists. --

(1) In general. -- Nothing in this section shall require the capitalization of any qualified creative expense.

(2) Qualified creative expense. -- For purposes of this subsection, the term "qualified creative expense" means any expense ---

(A) which is paid or incurred by an individual in the trade or business of such individual (other than as an employee) of being a writer, photographer, or artist, and

(B) which, without regard to this section, would be allowable as a deduction for the taxable year.

Such term does not include any expense related to printing, photographic plates, motion picture films, video tapes, or similar items.

(3) Definitions. -- For purposes of this subsection 00

(A) Writer. -- The term "writer" means any individual if the person efforts of such individual create (or may reasonably be expected to create) a literary manuscript, musical composition (including any accompanying words), or dance score.

(B) Photographer. -- The term "photographer" means any individual if the personal efforts of such individual create (or may reasonably be expected to create) a photograph or photographic negative or transparency.

(C) Artist. --

(i) In general. -- The term "artist" means any individual if the personal efforts of such individual create (or may reasonably be expected to create) a picture, painting, sculpture, statue, etching, drawing, cartoon, graphic design, or original print edition.

(ii) Criteria. -- In determining whether any expense is paid or incurred in the trade or business of being an artist, the following criteria shall be taken into account:

(I) The originality and uniqueness of the item created (or to be created).

(II) The predominance of aesthetic value over utilitarian value of the item created (or to be created).

(D) Treatment of certain corporations --

(i) In general. -- If --

(I) substantially all of the stock of a corporation is owned by a qualified employee-owner and members of his family (as defined in section 267(c)(4)), and

(II) the principal activity of such corporation is performance of personal services directly related to the activities of the qualified employee-owner and such services are substantial performed by the qualified employee-owner,

this subsection shall apply to any expense of such corporation which directly relates to the activities of such employee-owner in the same manner as if such expense were incurred by such employee-owner,

(ii) Qualified employee-owner. -- For purposes of this subparagraph, the term "qualified employee-owner" means any individual who is an employee-owner of the corporation (as defined in section 269A(b)(2)) and who is a write, photographer, or artist.

(i) Regulations. -- The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purpose of this section including --

(1) regulations to prevent the use of related parties, pass-thru entities, or intermediaries to avoid the application of this section, and

(2) regulations providing for simplified procedures for the application of this section in the case of property described in subsection (b)(2).

264. Certain amounts paid in connection with insurance contracts

(a) General rule. -- No deduction shall be allowed for --

(1) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance endowment, or annuity contract.

(3) Except as provided in subsection (c), any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise).

(4) Any interest paid or accrued on any indebtedness with respect to 1 or more life insurance policies owned by the taxpayer covering the life of any individual who --

(A) is an officer or employee of, or

(B) is financially interest in,

any trade or business carried on by the taxpayer to the extent that the aggregate amount of such indebtedness with respect to policies covering such individual exceeds \$50,000.

Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954. Paragraph (3) shall apply only in respect of contracts purchased after August 6, 1963. Paragraph (4) shall apply with respect to contracts purchased after June 20, 1986.

(b) Contracts treated as single premium contracts. -- For purposes of subsection (a)(2), a contract shall be treated as a single premium contract --

(1) if substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased, or

(2) if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract.

(c) Exceptions. -- Subsection (a)(3) shall not apply to any amount paid or accrued by a person during a taxable year on indebtedness incurred or continued as part of a plan referred to in subsection (a)(3) --

(1) if no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness,

(2) if the total of the amounts paid or accrued by such person during such taxable year for which (without regard to this paragraph) no deduction would be allowable by reason of subsection (a)(3) does not exceed \$100,

(3) if such amount was paid or accrued on indebtedness incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in his financial obligations, or

(4) if such indebtedness was incurred in connection with his trade or business.

For purposes of applying paragraph (1), if there is a substantial increase in the premiums on a contract, a new 7-year period described in such paragraph with respect to such contract shall commence on the date the first such increased premium is paid.

265. Expenses and interest relating to tax-exempt income

(a) General rule. -- No deduction shall be allowed for --

(1) Expenses. -- Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle, or any amount otherwise allowable under section 212 (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.

(2) Interest. -- Interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle.

(3) Certain regulated investment companies. -- In the case of a regulated investment company which distributes during the taxable year an exempt-interest dividend (including exempt-interest dividends paid after the close of the taxable year as described in section 855), that portion of any amount otherwise allowable as a deduction which the amount of the income of such company wholly exempt from taxes under this subtitle bears to the total of such exempt income and its gross income (excluding from gross income, for this purpose, capital gain net

income, as defined in section 1222(9)).

(4) Interest related to exempt-interest dividends. -- Interest on indebtedness incurred or continued to purchase or carry shares of stock of a regulated investment company which during the taxable year of the holder thereof distributes exempt-interest dividends.

(5) Special rules for application of paragraph (2) in the case of short sales. -- For purposes of paragraph (2) --

(A) In general. -- The term "interest" includes any amount paid or incurred --

(i) By any person making a short sale in connection with personal property used in such short sale, or

(ii) by any other person for the use of any collateral with respect to such short sale.

(B) Exception where no return on cash collateral. -- If --

(i) the taxpayer provides cash as collateral for any short sale, and

(ii) the taxpayer receives no material earnings on such cash during the period of the sale, subparagraph (A)(i) shall not apply to such short sale.

(6) Section not to apply with respect to parsonage and military housing allowances. -- No deduction shall be denied under this section for interest on a mortgage on, or real property taxes on, the home of the taxpayer by reason of the receipt of an amount as --

(A) a military housing allowance, or

(B) a parsonage allowance excludable from gross income under section 107.

(b) Pro rata allocation of interest expense of financial institutions to tax-exempt interest.

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(1) In general. -- In the case of a financial institution, no deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to tax-exempt interest.

(2) Allocation. -- For purposes of paragraph (1), the portion of the taxpayer's interest expense which is allocable to tax-exempt interest is an amount which bears the same ratio to such interest expense as --

(A) the taxpayer's average adjusted bases (within the meaning of section 1016) of tax-exempt obligations acquired after August 7, 1986, bears to

(B) such average adjusted bases for all assets of the taxpayer.

(3) Exception for certain tax-exempt obligations. --

(A) In general. -- Any qualified tax-exempt obligation acquired after August 7, 1986, shall be treated for purposes of paragraph (2) and section 291(e)(1)(B) as if it were acquired on August 7, 1986.

(B) Qualified tax-exempt obligation. --

(i) In general. -- For purposes of subparagraph (A), the term "qualified tax-exempt obligation" means a tax-exempt obligation --

(I) which is issued after August 7, 1986, by a qualified small issuer,

(II) which is not a private activity bond (as defined in section 141), and

(III) which is designated by the issuer for purposes of this paragraph.

(ii) Certain bonds not treated as private activity bonds. --- For purposes of clause (i)(II), there shall not be treated as a private activity bond-

(I) any qualified 501(c)(3) bond (as defined in section 145), or of obligations issued to refund) an obligation issued before August 8, 1986, which was not an industrial development bond (as defined in section 103(b)(2) as in effect on the day before the enactment of the Tax Reform Act of 1986) or a private loan bond (as defined in section 103(o)(2)(A), as so in effect, but without regard to any exemption from such definition other than section 103(o)(2)(A)).

(C) Qualified small issuer. --

(i) In general. -- For purposes of subparagraph (B), the term "qualified small issuer" means, with respect to obligations issued during any calendar year, any issuer if the reasonably anticipated amount of tax-exempt obligations (other than obligations described in clause(ii)) which will be issued by such issuer during such calendar year does not exceed \$10,000,000.

(ii) Obligations not taken into account in determining status as qualified small issuer. -- For purposes of clause (i), an obligation is described in this clause if such obligation is --

(I) a private activity bond (other than a qualified 501(c)(3) bond, as defined in section 145),

(II) an obligation to which section 141(a) does not apply by reason of section 1312, 1313, 1316(g), or 1317 of the Tax Reform Act of 1986 and which would (if issued on August 15, 1986) have been an industrial development bond (as defined in section 103(b)(2) as in effect, on the day before the date of the enactment of such Act) or a private loan bond (as defined in section 103(o)(2)(A), as so in effect, but without regard to any exception from such definition other than section 103(o)(2)(A)), or