

**TECHNICAL EXPLANATION OF H.R. 5970 THE
“ESTATE TAX AND EXTENSION OF TAX
RELIEF ACT OF 2006 (“ETETRA”)
AS INTRODUCED IN THE HOUSE ON JULY 28, 2006**

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



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INTRODUCTION

This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of H.R. 5970, the “Estate Tax and Extension of Tax Relief Act of 2006, (“ETETRA”)” as introduced in the House on July 28, 2006.

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I. REFORM AND EXTENSION OF ESTATE TAX AFTER 2009

A. Extension of Estate Tax After 2009; Modification of Estate and Gift Taxes After 2009 (secs. 2001, 2010, 2502, and 2505 of the Code)

Present Law

In general

A gift tax is imposed on certain lifetime transfers and an estate tax is imposed on certain transfers at death. A generation skipping transfer tax generally is imposed on certain transfers, either directly or in trust or similar arrangement, to a “skip person” (i.e., a beneficiary in a generation more than one generation younger than that of the transferor). Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions.

Exemption equivalent amounts and applicable tax rates

In general

Under present law in effect through 2009 and after 2010, a unified credit is available with respect to taxable transfers by gift and at death. The unified credit offsets tax computed at the lowest estate and gift tax rates.

Prior to 2004, the estate and gift taxes were fully unified, such that a single graduated rate schedule and a single effective exemption amount of the unified credit applied for purposes of determining the tax on cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. For years 2004 through 2009, the gift tax and the estate tax continue to be determined using a single graduated rate schedule, but the effective exemption amount allowed for estate tax purposes is increased above the effective exemption amount allowed for gift tax purposes, as described below.

Under present law in effect through 2009 and after 2010, the generation skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate on cumulative generation skipping transfers in excess of the exemption amount in effect at the time of the transfer. The generation skipping transfer tax exemption for a given year (prior to repeal, discussed below) is equal to the unified credit effective exemption amount for estate tax purposes.

Increase in unified credit effective exemption amount and reduction in estate and gift tax rates under the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”)

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”), the estate, gift, and generation skipping transfer taxes are gradually reduced between 2002 and 2009. In 2002, the unified credit effective exemption amount (for both estate and gift tax purposes) increased to \$1 million, and the highest estate and gift tax rate was 50 percent. In 2003, the highest estate and gift tax rate was 49 percent. In 2004, the highest estate and gift tax

rate was 48 percent, and the unified credit effective exemption amount for estate tax purposes increased to \$1.5 million. (The unified credit effective exemption amount for gift tax purposes remained at \$1 million in 2004 and later years, as increased in 2002.) In 2005, the highest estate and gift tax rate was 47 percent. For 2006, the highest estate and gift tax rate is 46 percent, and the unified credit effective exemption amount for estate tax purposes is increased to \$2 million, also the amount for 2007 and 2008. In 2007 and 2008, the highest estate and gift tax rate is 45 percent. In 2009, the unified credit effective exemption amount for estate tax purposes is increased to \$3.5 million.

Repeal of estate and generation skipping transfer taxes in 2010; modifications to gift tax

Under EGTRRA, the estate and generation skipping transfer taxes are repealed for decedents dying and generation skipping transfers made during 2010. The gift tax remains in effect during 2010, with a \$1 million exemption amount and a gift tax rate equal to the top individual income tax rate of 35 percent.

Also in 2010, except as provided in regulations, certain transfers in trust are treated as transfers of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions of the Code.²

The following table summarizes the estate and gift tax rates and unified credit effective exemption amount for estate tax purposes from 2002 through 2010.

² EGTRRA sec. 511(e). EGTRRA's Conference Report (H.R. Rep. 107-84) stated that a transfer in trust will be treated as a taxable gift. Section 411 of the "Job Creation and Worker Assistance Act of 2002" includes a technical correction to clarify that the effect of section 511(e) of EGTRRA (effective for gifts made after 2009) is to treat certain transfers in trust as transfers of property by gift. The result of the clarification is that the gift tax annual exclusion and the marital and charitable deductions may apply to such transfers. Under the provision as clarified, certain amounts transferred in trust will be treated as transfers of property by gift, despite the fact that such transfers would be regarded as incomplete gifts or would not be treated as transferred under the law applicable to gifts made prior to 2010. For example, if in 2010 an individual transfers property in trust to pay the income to one person for life, and the remainder to such persons and in such portions as the settlor may decide, then the entire value of the property will be treated as being transferred by gift under the provision, even though the transfer of the remainder interest in the trust would not be treated as a completed gift under current Treasury Regulation section 25.2511-2(c). Similarly, if in 2010 an individual transfers property in trust to pay the income to one person for life and makes no transfer of a remainder interest, the entire value of the property will be treated as being transferred by gift under the provision.

Estate and Generation Skipping Transfer Tax Exemption Amounts and Estate and Gift Tax Rates for 2002-2009

Calendar year	Estate and generation skipping transfer tax exemption	Highest estate and gift tax rates
2002	\$1 million	50%
2003	\$1 million	49%
2004	\$1.5 million	48%
2005	\$1.5 million	47%
2006	\$2 million	46%
2007	\$2 million	45%
2008	\$2 million	45%
2009	\$3.5 million	45%
2010	N/A (taxes repealed)	35% (gift tax only)

Reinstatement of the estate and generation skipping transfer taxes for decedents dying and generation skipping transfers made after December 31, 2010

The estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions (including repeal of the estate and generation skipping transfer taxes) will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, in general, the estate, gift, and generation skipping transfer tax rates and exemption amounts as in effect prior to 2002 will apply for estates of decedents dying, gifts made, or generation skipping transfers made in 2011 or later years. A single graduated rate schedule with a top rate of 55 percent and a single effective exemption amount of \$1 million will apply for purposes of determining the tax on cumulative taxable transfers made by a taxpayer by lifetime gift or bequest.

In addition, as a result of the EGTRRA sunset, the modification to the gift tax rules for certain transfers in trust, described above, will not apply for gifts made after December 31, 2010.

Basis in property received

In general

Gain or loss, if any, on the disposition of property is measured by the taxpayer's amount realized (i.e., gross proceeds received) on the disposition, less the taxpayer's basis in such property. Basis generally represents a taxpayer's investment in property, with certain adjustments required after acquisition. For example, basis is increased by the cost of capital

improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Basis in property received by lifetime gift

Under present law, property received from a donor of a lifetime gift generally takes a carryover basis. “Carryover basis” means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. The basis of a lifetime gift, however, generally cannot exceed the property’s fair market value on the date of the gift. If the basis of the property is greater than the fair market value of the property on the date of the gift, then, for purposes of determining loss, the basis is the property’s fair market value on the date of the gift.

Basis in property received from a decedent who dies before 2010

Under present law in effect through 2009, property passing from a decedent’s estate generally takes a stepped-up basis. “Stepped-up basis” for estate tax purposes means that the basis of property passing from a decedent’s estate generally is the fair market value on the date of the decedent’s death (or, if the alternate valuation date is elected, the earlier of six months after the decedent’s death or the date the property is sold or distributed by the estate). This step up in basis eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent’s death. If the value of property on the date of the decedent’s death is less than its adjusted basis, the property takes a stepped-down basis when it passes from a decedent’s estate. This stepped-down basis eliminates the tax benefit from any unrealized loss.

There is an exception to the rule that assets subject to the Federal estate tax receive stepped-up basis in the case of “income in respect of a decedent.” The basis of assets that are “income in respect of a decedent” is a carryover basis (i.e., the basis of such assets to the estate or heir is the same as it was to the decedent) increased by estate tax paid on such assets. Income in respect of a decedent generally includes rights to income earned, but not recognized, by the date of death (e.g., wages that were earned, but not paid, before death), individual retirement accounts (IRAs), and assets held in accounts governed by section 401(k).

In community property states, a surviving spouse’s one-half share of community property held by the decedent and the surviving spouse generally is treated as having passed from the decedent and, thus, is eligible for stepped-up basis. Under present law in effect through 2009, this rule applies if at least one-half of the whole of the community interest is includible in the decedent’s gross estate.

Under present law in effect through 2009, stepped-up basis treatment generally is denied to certain interests in foreign entities. Stock or securities in a foreign personal holding company take a carryover basis, and stock in a passive foreign investment company (including those for which a mark-to-market election has been made) generally takes a carryover basis, except that a passive foreign investment company for which a decedent shareholder had made a qualified electing fund election is allowed a stepped-up basis. Stock in a foreign investment company takes a stepped up basis reduced by the decedent’s ratable share of the company’s accumulated

earnings and profits, and stock owned by a decedent in a domestic international sales corporation (or former domestic international sales corporation) takes a stepped-up basis reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date (i.e., generally the date of the decedent's death unless an alternate valuation date is elected).

Basis in property received from a decedent who dies during 2010

In 2010, upon repeal of the estate tax, the rules providing for stepped-up basis in property acquired from a decedent are repealed, and a modified carryover basis regime is to take effect.³ Under this regime, recipients of property acquired from a decedent at the decedent's death receive a basis equal to the lesser of the decedent's adjusted basis or the fair market value of the property on the date of the decedent's death. The modified carryover basis rules apply to property acquired by bequest, devise, or inheritance, or property acquired by the decedent's estate from the decedent, property passing from the decedent to the extent such property passed without consideration, and certain other property to which the prior law rules apply, other than property that is income in respect of a decedent.⁴ Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, the character of gain on the sale of property received from a decedent's estate is carried over to the heir. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir.

An executor generally may increase (i.e., step up) the basis in assets owned by the decedent and acquired by the beneficiaries at death, subject to certain special rules and exceptions. Under these rules, each decedent's estate generally is permitted to increase the basis of assets transferred by up to a total of \$1.3 million. The \$1.3 million is increased by the amount of unused capital losses, net operating losses, and certain "built-in" losses of the decedent. In addition, the basis of property transferred to a surviving spouse may be increased by an additional \$3 million. Thus, the basis of property transferred to surviving spouses may be increased by a total of \$4.3 million. Nonresidents who are not U.S. citizens may be allowed to increase the basis of property by up to \$60,000. The \$60,000, \$1.3 million, and \$3 million amounts are adjusted annually for inflation occurring after 2010.

Repeal of modified carryover basis regime for determining basis in property received from a decedent who dies after December 31, 2010

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the modified carryover basis regime in effect for determining basis in property passing from a decedent who dies during 2010 does not apply for purposes of determining basis

³ Sec. 1022.

⁴ Secs. 1014(b)(2) and (3).

in property received from a decedent who dies after December 31, 2010. After that time, the law in effect prior to 2010, which generally provides for stepped-up basis in property passing from a decedent, will apply.

State death tax credit; deduction for State death taxes paid

State death tax credit under prior law

Prior to 2005, a credit was allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes (“death taxes”) actually paid to any State or the District of Columbia with respect to any property included in the decedent’s gross estate. The maximum amount of credit allowable for State death taxes was determined under a graduated rate table, the top rate of which was 16 percent, based on the size of the decedent’s adjusted taxable estate. Most States imposed a “pick-up” or “soak-up” estate tax, which served to impose a State tax equal to the maximum Federal credit allowed.

Phase-out of State death tax credit; deduction for State death taxes paid

Under EGTRRA, the amount of allowable State death tax credit was reduced from 2002 through 2004. For decedents dying after 2004, the State death tax credit was repealed and replaced with a deduction for death taxes actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent. Such State taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.

Reinstatement of State death tax credit for decedents dying after December 31, 2010

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, neither the EGTRRA modifications to the State death tax credit nor the replacement of the credit with a deduction applies for decedents dying after December 31, 2010. Instead, the State death tax credit as in effect for decedents who died prior to 2002 will apply.

Exclusions and deductions

Gift tax annual exclusion

Under present law, donors of lifetime gifts are provided an annual exclusion of \$12,000 (for 2006) on transfers of present interests in property to any one donee during the taxable year. If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is \$24,000 for 2006. Unlimited transfers between spouses are permitted without imposition of a gift tax. The dollar amounts are indexed for inflation.

Transfers to a surviving spouse

In general.—A 100-percent marital deduction generally is permitted for the value of property transferred between spouses for estate and gift tax purposes. In addition, transfers of “qualified terminable interest property” also are eligible for the marital deduction. “Qualified terminable interest property” is property: (1) that passes from a spouse, (2) in which the surviving or donee spouse has a “qualifying income interest for life,” and (3) to which an election under these rules applies. A “qualifying income interest for life” exists if: (1) the surviving or donee spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or has the right to use the property during such spouse’s life, and (2) no person has the power to appoint any part of the property to any person other than the surviving or donee spouse.

Transfers to surviving spouses who are not U.S. citizens.—A marital deduction generally is denied for property passing to a surviving spouse who is not a citizen of the United States. A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution.

There is an estate tax imposed on (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse. The tax is computed as an additional estate tax on the estate of the first spouse to die.

Provisions affecting small and family-owned businesses and farms

Special-use valuation

An executor may elect to value for estate tax purposes certain “qualified real property” used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value. The maximum reduction in value for such real property is \$900,000 for 2006. Real property generally can qualify for special-use valuation if at least 50 percent of the adjusted value of the decedent’s gross estate consists of a farm or closely-held business assets in the decedent’s estate (including both real and personal property) and at least 25 percent of the adjusted value of the gross estate consists of farm or closely-held business property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent’s family for five of the eight years before the decedent’s death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent’s death, an additional estate tax is imposed in order to recapture the entire estate-tax benefit of the special-use valuation.

Family-owned business deduction

Prior to 2004, an estate was permitted to deduct the adjusted value of a qualified family-owned business interest of the decedent, up to \$675,000.⁵ A qualified family-owned business interest generally is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if the decedent's family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns at least 30 percent of the trade or business.

To qualify for the exclusion, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, at least one qualified heir (or member of the qualified heir's family) is required to materially participate in the trade or business for at least 10 years following the decedent's death. The qualified family-owned business rules provide a graduated recapture based on the number of years after the decedent's death within which a disqualifying event occurred.

In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. However, the 10-year recapture period can be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

EGTRRA repealed the qualified family-owned business deduction for estates of decedents dying after December 31, 2003. As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the qualified family-owned business deduction will be available to estates of decedents dying after December 31, 2010.

Installment payment of estate tax for closely held businesses

Under present law, the estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10). An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely held business exceeds 35 percent of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and

⁵ The qualified family-owned business deduction and the unified credit effective exemption amount are coordinated. If the maximum deduction amount of \$675,000 is elected, then the unified credit effective exemption amount is \$625,000, for a total of \$1.3 million. If the qualified family-owned business deduction is less than \$675,000, then the unified credit effective exemption amount of \$625,000 is increased by the difference between \$675,000 and the amount of the qualified family-owned business deduction. However, the unified credit effective exemption amount cannot be increased above \$675,000.

interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax. A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first \$1 million (adjusted annually for inflation occurring after 1998; the inflation-adjusted amount for 2006 is \$1,200,000) in taxable value of a closely held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of \$1 million (adjusted for inflation) is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 of the Code (i.e., 45 percent of the Federal short-term rate plus two percentage points). Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

Generation-skipping transfer tax rules

A generation skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a “skip person” (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption generally equal to the estate tax effective exemption amount is provided for each person making generation skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person. Natural person or certain trusts may be skip persons. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person. A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip). If a transferor allocates generation skipping transfer tax exemption to a trust prior to the taxable distribution, generation skipping transfer tax may be avoided.

The tax rate on generation skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate in effect at the time of the transfer multiplied by the “inclusion ratio.” The inclusion ratio with respect to any property transferred in a generation skipping transfer indicates the amount of “generation skipping transfer tax exemption” allocated to a trust. The allocation of generation skipping transfer tax exemption effectually reduces the tax rate on a generation skipping transfer.

If an individual makes a direct skip during his or her lifetime, any unused generation-skipping transfer tax exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual can elect out of the automatic allocation for lifetime direct skips.

Explanation of Provision

Reunification of the estate and gift taxes; increase in the unified credit effective exemption amount; modification of the estate and gift tax rates

Under the provision, the estate and gift taxes are reunified, such that both a common unified credit effective exemption amount and a common rate schedule apply to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. Under the provision, the unified credit effective exemption amount for gift tax and estate tax purposes (the “basic exclusion amount”) generally is \$3.75 million for decedents dying and gifts made in 2010; \$4 million for decedents dying and gifts made in 2011; \$4.25 million for decedents dying and gifts made in 2012; \$4.5 million for decedents dying and gifts made in 2013; \$4.75 million for decedents dying and gifts made in 2014; and \$5 million for decedents dying and gifts made in 2015. For years after 2015, the \$5 million amount is indexed for inflation. A rate equal to the Federal long-term capital gains rate specified in Code section 1(h)(1)(C) (currently 15 percent in 2010 and 20 percent thereafter) in effect on the date of the decedent’s death (or, in the case of a lifetime gift, in effect on the last day of the calendar year in which the gift was made) applies to the first \$25 million of cumulative taxable transfers. Cumulative taxable transfers in excess of \$25 million are taxed at a rate of 40 percent in 2010, 38 percent in 2011, 36 percent in 2012, 34 percent in 2013, 32 percent in 2014, and 30 percent in years after 2014. The \$25 million amount described in the preceding two sentences is indexed for inflation beginning in 2016. As under present law, the generation skipping transfer tax exemption for a given year is equal to the unified credit effective exemption amount for estate tax purposes (the basic exclusion amount), and the generation skipping transfer tax rate for a given year will be determined using the highest estate and gift tax rate in effect for such year.

The following table summarizes the estate and gift tax rates and basic exclusion amount for estate and gift tax purposes for years after 2009.

**Estate and Gift Tax Basic Exclusion Amount and Estate
and Gift Tax Rates for Years after 2009**

Calendar year	Basic exclusion amount	Highest estate and gift tax rates
2010	\$3.75 million	40%
2011	\$4 million	38%
2012	\$4.25 million	36%
2013	\$4.5 million	34%
2014	\$4.75 million	32%
2015	\$5 million	30%
Years after 2015	\$5 million indexed for inflation	30%

As under present law, the tax on taxable transfers for a year is determined by computing a tentative tax on the cumulative value of current year transfers and all gifts made by a decedent after December 31, 1976, and subtracting from the tentative tax the amount of gift tax that would have been paid by the decedent on taxable gifts after December 31, 1976, if the estate tax rate schedule in effect on the date of the decedent's death had been in effect on the date of the prior-year gifts. This computation generally operates to place present-year transfers on top of prior year transfers for purposes of applying the marginal tax rates. To account for differences between the revised rate schedule effective in 2010 and certain prior year rates, the provision generally provides that the rates in effect on the date of the decedent's death are to be used in determining the tax on prior transfers and the credit available to offset such tax for purposes of performing the computation described in this paragraph.

Example.—Assume in 1987 an individual makes taxable gifts of \$1 million and dies in 2015 with a taxable estate of \$9 million. Under the bill, the estate tax (before credit) is \$1,920,000. This is the excess of \$2,000,000 (20 percent⁶ of \$10 million) over \$80,000. \$80,000 is the gift tax that would have been payable on the 1987 gifts, assuming the 2015 estate tax rates had applied in computing the gift tax payable in 1987, using the 20-percent rate in computing both the 1987 gift tax and gift tax credit amounts. If the 20-percent rate had applied to the gifts made in 1987, the gift tax (before credit) would have been \$200,000 (20 percent of \$1 million) and a gift tax credit of \$120,000 would have been allowed (\$200,000 - \$120,000 = \$80,000). \$120,000 is the applicable credit amount computed at a 20 percent rate on \$600,000 (the dollar amount under section 6018(a)(1) for 1987). The estate is allowed a credit of

⁶ As discussed above, the provision provides that the estate and gift tax rate for taxable transfers not in excess of \$25 million (indexed for inflation beginning in 2016) generally is equal to the long-term capital gain rate specified in Code section 1(h)(1)(C). The long-term capital gain rate scheduled to be in effect after 2010 is 20 percent.

\$1,000,000 (20 percent of \$5 million). The net tax due is \$920,000 (\$1,920,000 less \$1,000,000).

Portability between spouses of unused unified credit effective exemption amount

Under the provision, for gift and estate tax purposes, any unified credit effective exemption amount that remains unused as of the death of a spouse who dies after December 31, 2009 (the “deceased spousal unused exclusion amount”), generally is available for use by such spouse’s surviving spouse, in addition to such surviving spouse’s own basic exclusion amount.⁷

The aggregate amount of unused exemption equivalent (the “aggregate deceased spousal unused exclusion amount”) that is available for use by a surviving spouse from all predeceased spouses in no event is permitted to exceed the basic exclusion amount in effect at any given time (e.g., \$5 million in 2015). As with the basic exclusion amount, a surviving spouse may use the aggregate deceased spousal unused exclusion amount for taxable transfers made during life or at death.

A deceased spousal unused exclusion amount is available to a surviving spouse only if an election is made on a timely filed estate tax return (including extensions) of the predeceased spouse on which such amount is computed, regardless of whether the predeceased spouse otherwise is required to file an estate tax return. In addition, notwithstanding the statute of limitations for assessing estate or gift tax with respect to a predeceased spouse, the bill provides that the Secretary of the Treasury may examine the return of a predeceased spouse for purposes of determining the deceased spousal unused exclusion amount available for use by the surviving spouse. Under the provision, the Secretary of the Treasury shall prescribe regulations as may be necessary or appropriate to carry out the rules described in this paragraph.

Example 1.—Assume that Husband 1 dies in 2015, having made taxable gifts of \$3 million and having no taxable estate. An election is made on Husband 1’s estate tax return to permit Wife to use Husband 1’s deceased spousal unused exclusion amount. As of Husband 1’s death, Wife has made no taxable gifts. Thereafter, Wife’s applicable exclusion amount is \$7 million (her \$5 million basic exclusion amount plus \$2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.

Example 2.—Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 predeceases Wife in a year in which the basic exclusion amount is assumed for purposes of this example to be \$5 million, having made no taxable gifts and having no taxable estate. An election is made on Husband 2’s estate tax return to permit Wife to use Husband 2’s deceased spousal unused exclusion amount. Although the deceased spousal unused exclusion amount from Husband 2 is \$5 million (the amount of his unused exclusion), only \$3 million of this amount is available for use by Wife, because she previously received the benefit of \$2 million of deceased spousal unused exclusion amount from Husband 1, and the provision places a limit equal to the basic exclusion amount (\$5 million for purposes of this

⁷ It is intended that unused exemption not be available for generation skipping transfer tax purposes.

example) on the aggregate deceased spousal unused exclusion amount available to a surviving spouse from all predeceased spouses.

Example 3.—Assume the same facts as in Example 2, except that Wife predeceases Husband 2 in a year in which the basic exclusion amount is assumed for purposes of this example to be \$5 million. Husband 2 had no prior spouses. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount. Wife made no taxable gifts and has a taxable estate of \$3 million. Under the provision, Husband 2's applicable exclusion amount is increased by \$4 million, i.e., the amount of the deceased spousal unused exclusion amount from Wife (computed as Wife's \$7 million applicable exclusion amount less her \$3 million taxable estate).

Other provisions

The provision makes permanent the repeal of the State death tax credit and does not allow a deduction for death taxes paid to any State or the District of Columbia. In addition, the provision makes permanent the repeal of the qualified family-owned business deduction.

The provision also repeals the modified carryover basis rules that, under EGTRRA, would apply for purposes of determining basis in property acquired from a decedent who dies in 2010. Under the provision, a recipient of property acquired from a decedent who dies after December 31, 2009, generally will receive date-of-death fair market value basis under the basis rules in effect under present law with respect to decedents dying prior to 2010.

The provision also makes permanent the EGTRRA provision (as modified by section 411 of the Job Creation and Worker Assistance Act of 2002) under which certain transfers in trust are treated as transfers of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions of the Code.

Effective date.—The provision is effective for estates of decedents dying, generation skipping transfers made, and gifts made after December 31, 2009.

II. EXTENSION AND EXPANSION OF CERTAIN TAX RELIEF PROVISIONS⁸

A. Extension and Modification of Certain Provisions

1. Above-the-line deduction for higher education expenses (sec. 222 of the Code)

Present Law

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year. Qualified tuition and related expenses include tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the deduction. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

The amount of qualified tuition and related expenses must be reduced by certain scholarships, educational assistance allowances, and other amounts paid for the benefit of such individual, and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain United States Savings Bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings account. Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion under section 529 is claimed with respect to expenses otherwise deductible under section 222. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope credit or Lifetime Learning credit is elected for such taxable year.

The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic term beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

For taxable years beginning in 2004 and 2005, the maximum deduction is \$4,000 for an individual whose adjusted gross income for the taxable year does not exceed \$65,000 (\$130,000 in the case of a joint return), or \$2,000 for other individuals whose adjusted gross income does not exceed \$80,000 (\$160,000 in the case of a joint return). No deduction is allowed for an individual whose adjusted gross income exceeds the relevant adjusted gross income limitations,

⁸ Some provisions that are identical or similar to provisions in this bill were included in other bills reported by the House Ways and Means Committee or the Senate Finance Committee, or passed by the House of Representatives or the Senate, during the 109th Congress. These bills include H.R. 4297, H.R. 5638, H.R. 4323, H.R. 4388, and S. 2020.

for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2005.

Explanation of Provision

The provision extends the tuition deduction for two years, through December 31, 2007.

Effective date.—The provision is effective for taxable years beginning after December 31, 2005.

2. Extension and modification of the new markets tax credit (sec. 45D of the Code)

Present Law

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity (“CDE”).⁹ The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years. The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available for a taxable year to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE. A qualified equity investment means stock (other than nonqualified preferred stock as defined in sec. 351(g)(2)) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder. Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any

⁹ Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554 (December 21, 2000).

loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.

A “low-income community” is a population census tract with either (1) a poverty rate of at least 20 percent or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family income). In the case of a population census tract located within a high migration rural county, low-income is defined by reference to 85 percent (rather than 80 percent) of statewide median family income. For this purpose, a high migration rural county is any county that, during the 20-year period ending with the year in which the most recent census was conducted, has a net out-migration of inhabitants from the county of at least 10 percent of the population of the county at the beginning of such period.

The Secretary has the authority to designate “targeted populations” as low-income communities for purposes of the new markets tax credit. For this purpose, a “targeted population” is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4702(20)) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who (A) are low-income persons; or (B) otherwise lack adequate access to loans or equity investments. Under such Act, “low-income” means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income or 80 percent of the statewide non-metropolitan area median family income.¹⁰ Under such Act, a targeted population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391, and is contiguous to one or more low-income communities.

A qualified active low-income community business is defined as a business that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in any low-income community; (2) a substantial portion of the tangible property of such business is used in a low-income community; (3) a substantial portion of the services performed for such business by its employees is performed in a low-income community; and (4) less than five percent of the average of the aggregate unadjusted bases of the property of such business is attributable to certain financial property or to certain collectibles.

The maximum annual amount of qualified equity investments is capped at \$2.0 billion per year for calendar years 2004 and 2005, and at \$3.5 billion per year for calendar years 2006 and 2007.

¹⁰ 12 U.S.C. 4702(17) defines “low-income” for purposes of 12 U.S.C. 4702(20).

Explanation of Provision

The provision extends the new markets tax credit through 2008, permitting up to \$3.5 billion in qualified equity investments for that calendar year. The provision also requires that the Secretary prescribe regulations to ensure that non-metropolitan counties receive a proportional allocation of qualified equity investments.

Effective date.—The provision is effective on the date of enactment.

3. Deduction of state and local general sales taxes (sec. 164 of the Code)

Present Law

For purposes of determining regular tax liability, an itemized deduction is permitted for certain State and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. The itemized deduction is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. For taxable years beginning in 2004 and 2005, at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction provided under present law for State and local income taxes. As is the case for State and local income taxes, the itemized deduction for State and local general sales taxes is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. Taxpayers have two options with respect to the determination of the sales tax deduction amount. Taxpayers may deduct the total amount of general State and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers may use tables created by the Secretary of the Treasury that show the allowable deduction. The tables are based on average consumption by taxpayers on a State-by-State basis taking into account number of dependents, modified adjusted gross income and rates of State and local general sales taxation. Taxpayers who live in more than one jurisdiction during the tax year are required to pro-rate the table amounts based on the time they live in each jurisdiction. Taxpayers who use the tables created by the Secretary may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats and other items specified by the Secretary. Sales taxes for items that may be added to the tables are not reflected in the tables themselves.

The term "general sales tax" means a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items. However, in the case of items of food, clothing, medical supplies, and motor vehicles, the fact that the tax does not apply with respect to some or all of such items is not taken into account in determining whether the tax applies with respect to a broad range of classes of items, and the fact that the rate of tax applicable with respect to some or all of such items is lower than the general rate of tax is not taken into account in determining whether the tax is imposed at one rate. Except in the case of a lower rate of tax applicable with respect to food, clothing, medical supplies, or motor vehicles, no deduction is allowed for any general sales tax imposed with respect to an item at a rate other than the general rate of tax. However, in the case of motor vehicles, if the rate of tax exceeds the general rate, such excess shall be disregarded and the general rate is treated as the rate of tax.

A compensating use tax with respect to an item is treated as a general sales tax, provided such tax is complementary to a general sales tax and a deduction for sales taxes is allowable with respect to items sold at retail in the taxing jurisdiction that are similar to such item.

Explanation of Provision

The present-law provision allowing taxpayers to elect to deduct State and local sales taxes in lieu of State and local income taxes is extended for two years (through December 31, 2007).

Effective date.—The provision applies to taxable years beginning after December 31, 2005.

4. Extension and modification of the research credit (sec. 41 of the Code)

Present Law

General rule

Prior to January 1, 2006, a taxpayer could claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceeded its base amount for that year.¹¹ Thus, the research credit was generally available with respect to incremental increases in qualified research.

A 20-percent research tax credit was also available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation was commonly referred to as the university basic research credit (see sec. 41(e)).

Finally, a research credit was available for a taxpayer's expenditures on research undertaken by an energy research consortium. This separate credit computation was commonly referred to as the energy research credit. Unlike the other research credits, the energy research credit applied to all qualified expenditures, not just those in excess of a base amount.

The research credit, including the university basic research credit and the energy research credit, expired on December 31, 2005.

Computation of allowable credit

Except for energy research payments and certain university basic research payments made by corporations, the research tax credit applied only to the extent that the taxpayer's

¹¹ Sec. 41.

qualified research expenses for the current taxable year exceeded its base amount. The base amount for the current year generally was computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage was the ratio that its total qualified research expenses for the 1984-1988 period bore to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) were assigned a fixed-base percentage of three percent.¹²

In computing the credit, a taxpayer's base amount could not be less than 50 percent of its current-year qualified research expenses.

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provided that all members of the same controlled group of corporations were treated as a single taxpayer (sec. 41(f)(1)). Under regulations prescribed by the Secretary, special rules applied for computing the credit when a major portion of a trade or business (or unit thereof) changed hands, under which qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business were treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage (sec. 41(f)(3)).

Alternative incremental research credit regime

Taxpayers were allowed to elect an alternative incremental research credit regime.¹³ If a taxpayer elected to be subject to this alternative regime, the taxpayer was assigned a three-tiered fixed-base percentage (that was lower than the fixed-base percentage otherwise applicable) and the credit rate likewise was reduced. Under the alternative incremental credit regime, a credit rate of 2.65 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equaled one percent of the taxpayer's average gross receipts for the four preceding years) but did not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A

¹² The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) was designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm would be assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. In the event that the research credit is extended beyond its expiration date, a start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage will be its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

¹³ Sec. 41(c)(4).

credit rate of 3.2 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of 1.5 percent but did not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of two percent. An election to be subject to this alternative incremental credit regime could be made for any taxable year beginning after June 30, 1996, and such an election applied to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury.

Eligible expenses

Qualified research expenses eligible for the research tax credit consisted of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).¹⁴ Notwithstanding the limitation for contract research expenses, qualified research expenses included 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

To be eligible for the credit, the research did not only have to satisfy the requirements of present-law section 174 (described below) but also had to be undertaken for the purpose of discovering information that is technological in nature, the application of which was intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which had to constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research did not qualify for the credit if substantially all of the activities related to style, taste, cosmetic, or seasonal design factors (sec. 41(d)(3)). In addition, research did not qualify for the credit: (1) if conducted after the beginning of commercial production of the business component; (2) if related to the adaptation of an existing business component to a particular customer's requirements; (3) if related to the duplication of an existing business component from a physical examination of the component itself or certain other information; or (4) if related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control (sec. 41(d)(4)). Research did not qualify for the credit if it was conducted outside the United States, Puerto Rico, or any U.S. possession.

¹⁴ Under a special rule enacted as part of the Small Business Job Protection Act of 1996, 75 percent of amounts paid to a research consortium for qualified research were treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium was a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and was organized and operated primarily to conduct scientific research, and (2) such qualified research was conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

Relation to deduction

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized.¹⁵ While the research credit was in effect, however, deductions allowed to a taxpayer under section 174 (or any other section) were reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year (Sec. 280C(c)). Taxpayers could alternatively elect to claim a reduced research tax credit amount (13 percent) under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

Explanation of Provision

The provision extends the research credit two years (for amounts paid or incurred after December 31, 2005, and before January 1, 2008). The provision also modifies the research credit for one year (for amounts paid or incurred after December 31, 2006, and before January 1, 2008).

The provision increases the rates of the alternative incremental credit: (1) a credit rate of three percent (rather than 2.65 percent) applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent; (2) a credit rate of four percent (rather than 3.2 percent) applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent; and (3) a credit rate of five percent (rather than 3.75 percent) applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent.

The provision also creates, at the election of the taxpayer, an alternative simplified credit for qualified research expenses. The alternative simplified research is equal to 12 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to 6 percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.

An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary. An election to use the alternative simplified credit may not be made for any taxable year for which an election to use the alternative incremental credit is in effect. A special transition rule applies which permits a taxpayer to elect to use the alternative simplified credit in lieu of the alternative incremental credit if such election

¹⁵ Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under section 174(a). Secs. 174(f)(2) and 59(e).

is made during the taxable year which includes the date of enactment of the provision. The transition rule only applies to the taxable year which includes the date of enactment.

Effective date.—The extension of the research credit applies to amounts paid or incurred after December 31, 2005. The modification of the alternative incremental credit and the creation of the alternative simplified credit are effective for amounts paid or incurred after December 31, 2006.

5. Work opportunity tax credit and welfare-to-work tax credit (sec. 51 and 51A of the Code)

Present Law

Work opportunity tax credit

Targeted groups eligible for the credit

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The eight targeted groups are: (1) certain families eligible to receive benefits under the Temporary Assistance for Needy Families Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income (SSI) benefits.

A high-risk youth is an individual aged 18 but not aged 25 on the hiring date who is certified by a designated local agency as having a principal place of abode within an empowerment zone, enterprise community, or renewal community. The credit is not available if such youth's principal place of abode ceases to be within an empowerment zone, enterprise community, or renewal community.

A qualified ex-felon is an individual certified by a designated local agency as: (1) having been convicted of a felony under State or Federal law; (2) being a member of an economically disadvantaged family; and (3) having a hiring date within one year of release from prison or conviction.

A food stamp recipient is an individual aged 18 but not aged 25 on the hiring date certified by a designated local agency as being a member of a family either currently or recently receiving assistance under an eligible food stamp program.

Qualified wages

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer's deduction for wages is reduced by the amount of the credit.

Calculation of the credit

The credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in

excess of \$6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is \$2,400 (40 percent of the first \$6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is \$1,200 (40 percent of the first \$3,000 of qualified first-year wages).

Certification rules

An individual is not treated as a member of a targeted group unless: (1) on or before the day on which an individual begins work for an employer, the employer has received a certification from a designated local agency that such individual is a member of a targeted group; or (2) on or before the day an individual is offered employment with the employer, a pre-screening notice is completed by the employer with respect to such individual, and not later than the 21st day after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for certification.

Minimum employment period

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

Coordination of the work opportunity tax credit and the welfare-to-work tax credit

An employer cannot claim the work opportunity tax credit with respect to wages of any employee on which the employer claims the welfare-to-work tax credit.

Other rules

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. Similarly wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. The work opportunity tax credit generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

Expiration

The work opportunity tax credit is not available for individuals who begin work for an employer after December 31, 2005.

Welfare-to-work tax credit

Targeted group eligible for the credit

The welfare-to-work tax credit is available on an elective basis to employers of qualified long-term family assistance recipients. Qualified long-term family assistance recipients are: (1)

members of a family that have received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that have received such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of the welfare-to-work tax credit) if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either Federal or State time limits, if they are hired within 2 years after the Federal or State time limits made the family ineligible for family assistance.

Qualified wages

Qualified wages for purposes of the welfare-to-work tax credit are defined more broadly than the work opportunity tax credit. Unlike the definition of wages for the work opportunity tax credit which includes simply cash wages, the definition of wages for the welfare-to-work tax credit includes cash wages paid to an employee plus amounts paid by the employer for: (1) educational assistance excludable under a section 127 program (or that would be excludable but for the expiration of sec. 127); (2) health plan coverage for the employee, but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129. The employer's deduction for wages is reduced by the amount of the credit.

Calculation of the credit

The welfare-to-work tax credit is available on an elective basis to employers of qualified long-term family assistance recipients during the first two years of employment. The maximum credit is 35 percent of the first \$10,000 of qualified first-year wages and 50 percent of the first \$10,000 of qualified second-year wages. Qualified first-year wages are defined as qualified wages (not in excess of \$10,000) attributable to service rendered by a member of the targeted group during the one-year period beginning with the day the individual began work for the employer. Qualified second-year wages are defined as qualified wages (not in excess of \$10,000) attributable to service rendered by a member of the targeted group during the one-year period beginning immediately after the first year of that individual's employment for the employer. The maximum credit is \$8,500 per qualified employee.

Certification rules

An individual is not treated as a member of the targeted group unless: (1) on or before the day on which an individual begins work for an employer, the employer has received a certification from a designated local agency that such individual is a member of the targeted group; or (2) on or before the day an individual is offered employment with the employer, a pre-screening notice is completed by the employer with respect to such individual, and not later than the 21st day after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for certification.

Minimum employment period

No credit is allowed for qualified wages paid to a member of the targeted group unless the number they work is at least 400 hours or 180 days in the first year of employment.

Coordination of the work opportunity tax credit and the welfare-to-work tax credit

An employer cannot claim the work opportunity tax credit with respect to wages of any employee on which the employer claims the welfare-to-work tax credit.

Other rules

The welfare-to-work tax credit incorporates directly or by reference many of these other rules contained on the work opportunity tax credit.

Expiration

The welfare-to-work credit is not available for individuals who begin work for an employer after December 31, 2005.

Explanation of Provision

First year of extension

The provision extends the work opportunity tax credit and welfare-to-work tax credits for one year without modification, respectively (for qualified individuals who begin work for an employer after December 31, 2005 and before January 1, 2007).

Second year of extension

In general

The provision then combines and extends the two credits for a second year (for qualified individuals who begin work for an employer after December 31, 2006 and before January 1, 2008).

Targeted groups eligible for the combined credit

The combined credit is available on an elective basis for employers hiring individuals from one or more of all nine targeted groups. The nine targeted groups are the present-law eight groups with the addition of the welfare-to-work credit/long-term family assistance recipient as the ninth targeted group.

The provision repeals the requirement that a qualified ex-felon be an individual certified as a member of an economically disadvantaged family.

The provision raises the age limit for the food stamp recipient category to include individuals aged 18 but not aged 40 on the hiring date.

Qualified wages

Qualified first-year wages for the eight work opportunity tax credit categories remain capped at \$6,000 (\$3,000 for qualified summer youth employees). No credit is allowed for second-year wages. In the case of long-term family assistance recipients, the cap is \$10,000 for

both qualified first-year wages and qualified second-year wages. The combined credit follows the work opportunity tax credit definition of wages which does not include amounts paid by the employer for: (1) educational assistance excludable under a section 127 program (or that would be excludable but for the expiration of sec. 127); (2) health plan coverage for the employee, but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129. For all targeted groups, the employer's deduction for wages is reduced by the amount of the credit.

Calculation of the credit

First-year wages.—For the eight work opportunity tax credit categories, the credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of \$6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee for members of any of the eight work opportunity tax credit targeted groups generally is \$2,400 (40 percent of the first \$6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit remains \$1,200 (40 percent of the first \$3,000 of qualified first-year wages). For the welfare-to-work/long-term family assistance recipients, the maximum credit equals \$4,000 per employee (40 percent of \$10,000 of wages).

Second year wages.—In the case of long-term family assistance recipients the maximum credit is \$5,000 (50 percent of the first \$10,000 of qualified second-year wages).

Certification rules

The provision changes the present-law 21-day requirement to 28 days.

Minimum employment period

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

Coordination of the work opportunity tax credit and the welfare-to-work tax credit

Coordination is no longer necessary once the two credits are combined.

Effective date.—Generally, the extension of the credits is effective for wages paid or incurred to a qualified individual who begins work for an employer after December 31, 2005, and before January 1, 2008. The consolidation of the credits and other modifications are effective for wages paid or incurred to a qualified individual who begins work for an employer after December 31, 2006, and before January 1, 2008.

6. Election to treat combat pay as earned income for purposes of the earned income credit (sec. 32 of the Code)

Present Law

In general

Subject to certain limitations, military compensation earned by members of the Armed Forces while serving in a combat zone may be excluded from gross income. In addition, for up to two years following service in a combat zone, military personnel may also exclude compensation earned while hospitalized from wounds, disease, or injuries incurred while serving in the zone.

Child credit

Combat pay that is otherwise excluded from gross income under section 112 is treated as earned income which is taken into account in computing taxable income for purposes of calculating the refundable portion of the child credit.

Earned income credit

Any taxpayer may elect to treat combat pay that is otherwise excluded from gross income under section 112 as earned income for purposes of the earned income credit. This election is available with respect to any taxable year ending after the date of enactment and before January 1, 2007.

Explanation of Provision

The provision extends for one year (through December 31, 2007) the availability of the election to treat combat pay that is otherwise excluded from gross income under section 112 as earned income for purposes of the earned income credit.

Effective date.—The provision is effective in taxable years beginning after December 31, 2006.

7. Qualified zone academy bonds (sec. 1397E of the Code)

Present Law

Tax-exempt bonds

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of these governmental units. Activities that can be financed with these tax-exempt bonds include the financing of public schools (sec. 103).

An issuer must file with the IRS certain information in order for a bond issue to be tax-exempt.¹⁶ Generally, this information return is required to be filed no later the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue “qualified zone academy bonds” (sec. 1397E). A total of \$400 million of qualified zone academy bonds may be issued annually in calendar years 1998 through 2005. The \$400 million aggregate bond cap is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

Financial institutions that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. A taxpayer holding a qualified zone academy bond on the credit allowance date is entitled to a credit. The credit is includable in gross income (as if it were a taxable interest payment on the bond), and may be claimed against regular income tax and AMT liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bond is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond.

“Qualified zone academy bonds” are defined as any bond issued by a State or local government, provided that: (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy” (“qualified zone academy property”) and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a “qualified zone academy” if: (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community designated under the Code or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

Issuers of qualified zone academy bonds are not required to report issuance of such bonds to the IRS under present law.

¹⁶ Sec. 149(e).

Arbitrage restrictions on tax-exempt bonds

To prevent States and local governments from issuing more tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods” before funds are needed for the purpose of the borrowing) or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, profits that are earned during these periods or on such investments must be rebated to the Federal Government. Governmental bonds are subject to less restrictive arbitrage rules than most private activity bonds. The arbitrage rules do not apply to qualified zone academy bonds.

Explanation of Provision

The provision extends the present-law provision for two years (through December 31, 2007).

In addition, the provision imposes the arbitrage requirements of section 148 that apply to interest-bearing tax-exempt bonds to qualified zone academy bonds. Principles under section 148 and the regulations thereunder shall apply for purposes of determining the yield restriction and arbitrage rebate requirements applicable to qualified zone academy bonds. For example, for arbitrage purposes, the yield on an issue of qualified zone academy bonds is computed by taking into account all payments of interest, if any, on such bonds, i.e., whether the bonds are issued at par, premium, or discount. However, for purposes of determining yield, the amount of the credit allowed to a taxpayer holding qualified zone academy bonds is not treated as interest, although such credit amount is treated as interest income to the taxpayer.

The provision also imposes new spending requirements for qualified zone academy bonds. An issuer of qualified zone academy bonds must reasonably expect to and actually spend 95 percent or more of the proceeds of such bonds on qualified zone academy property within the five-year period that begins on the date of issuance. To the extent less than 95 percent of the proceeds are used to finance qualified zone academy property during the five-year spending period, bonds will continue to qualify as qualified zone academy bonds if unspent proceeds are used within 90 days from the end of such five-year period to redeem any nonqualified bonds. For these purposes, the amount of nonqualified bonds is to be determined in the same manner as Treasury regulations under section 142. In addition, the provision provides that the five-year spending period may be extended by the Secretary upon the issuer’s request.

In addition, issuers of qualified zone academy bonds are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds.

Effective date.—The provision extending issuance authority is effective for bonds issued after December 31, 2005. The provisions imposing arbitrage restrictions, reporting requirements, and spending requirements apply to bonds issued after the date of enactment with respect to allocations of the annual aggregate bond cap for calendar years after 2005.

8. Above-the-line deduction for certain expenses of elementary and secondary school teachers (sec. 62 of the Code)

Present Law

In general, ordinary and necessary business expenses are deductible (sec. 162). However, in general, unreimbursed employee business expenses are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income. An individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of \$145,950 (for 2005). In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed an above-the-line deduction. Specifically, for taxable years beginning prior to January 1, 2006, an above-the-line deduction is allowed for up to \$250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under section 135 (relating to education savings bonds), 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year. A school means any school which provides elementary education or secondary education, as determined under State law.

The above-the-line deduction for eligible educators is not allowed for taxable years beginning after December 31, 2005.

Explanation of Provision

The present-law provision is extended for two years, through December 31, 2007.

Effective date.—The provision is effective for expenses paid or incurred in taxable years beginning after December 31, 2005.

9. Extension and expansion to petroleum products of expensing for environmental remediation costs (sec. 198 of the Code)

Present Law

Present law allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.¹⁷ Treasury regulations provide that the cost of incidental repairs that neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense. Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury regulations define “capital expenditures” as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use. Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

Taxpayers may elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred.¹⁸ The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property, which would otherwise be allocated to the site under the principles set forth in *Commissioner v. Idaho Power Co.*¹⁹ and section 263A, are treated as qualified environmental remediation expenditures.

A “qualified contaminated site” (a so-called “brownfield”) generally is any property that is held for use in a trade or business, for the production of income, or as inventory and is certified by the appropriate State environmental agency to be an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance. Both urban and rural property may qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (“CERCLA”)²⁰ cannot qualify as targeted areas. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use. Petroleum products generally are not regarded as hazardous substances for

¹⁷ Sec. 162.

¹⁸ Sec. 198.

¹⁹ 418 U.S. 1 (1974).

²⁰ Pub. L. No. 96-510 (1980).

purposes of section 198 (except for purposes of determining qualified environmental remediation expenditures in the “Gulf Opportunity Zone” under section 1400N(g), as described below).²¹

In the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under section 198 is treated as a depreciation deduction and the property is treated as section 1245 property. Thus, deductions for qualified environmental remediation expenditures are subject to recapture as ordinary income upon a sale or other disposition of the property. In addition, sections 280B (demolition of structures) and 468 (special rules for mining and solid waste reclamation and closing costs) do not apply to amounts that are treated as expenses under this provision.

Eligible expenditures are those paid or incurred before January 1, 2006.

Under section 1400N(g), the above provisions apply to expenditures paid or incurred to abate contamination at qualified contaminated sites in the Gulf Opportunity Zone (defined as that portion of the Hurricane Katrina Disaster Area determined by the President to warrant individual or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina) before January 1, 2008; in addition, within the Gulf Opportunity Zone section 1400N(g) broadens the definition of hazardous substance to include petroleum products (defined by reference to section 4612(a)(3)).

Explanation of Provision

The provision extends for two years the present-law provisions relating to environmental remediation expenditures (through December 31, 2007).

In addition, the provision expands the definition of hazardous substance to include petroleum products. Under the provision, petroleum products are defined by reference to section 4612(a)(3), and thus include crude oil, crude oil condensates and natural gasoline.²²

Effective date.—The provision applies to expenditures paid or incurred after December 31, 2005, and before January 1, 2008.

²¹ Section 101(14) of CERCLA specifically excludes “petroleum, including crude oil or any fraction thereof which is not otherwise specifically listed or designated as a hazardous substance under subparagraphs (A) through (F) of this paragraph,” from the definition of “hazardous substance.”

²² The present law exceptions for sites on the national priorities list under CERCLA, and for substances with respect to which a removal or remediation is not permitted under section 104 of CERCLA by reason of subsection (a)(3) thereof, would continue to apply to all hazardous substances (including petroleum products).

10. Tax incentives for investment in the District of Columbia (sec. 1400, 1400A, 1400B, and 1400C of the Code)

Present Law

In general

The Taxpayer Relief Act of 1997 designated certain economically depressed census tracts within the District of Columbia as the District of Columbia Enterprise Zone (the “D.C. Zone”), within which businesses and individual residents are eligible for special tax incentives. The census tracts that compose the D.C. Zone are (1) all census tracts that presently are part of the D.C. enterprise community designated under section 1391 (i.e., portions of Anacostia, Mt. Pleasant, Chinatown, and the easternmost part of the District), and (2) all additional census tracts within the District of Columbia where the poverty rate is not less than 20 percent. The D.C. Zone designation remains in effect for the period from January 1, 1998, through December 31, 2005. In general, the tax incentives available in connection with the D.C. Zone are a 20-percent wage credit, an additional \$35,000 of section 179 expensing for qualified zone property, expanded tax-exempt financing for certain zone facilities, and a zero-percent capital gains rate from the sale of certain qualified D.C. zone assets.

Wage credit

A 20-percent wage credit is available to employers for the first \$15,000 of qualified wages paid to each employee (i.e., a maximum credit of \$3,000 with respect to each qualified employee) who (1) is a resident of the D.C. Zone, and (2) performs substantially all employment services within the D.C. Zone in a trade or business of the employer.

Wages paid to a qualified employee who earns more than \$15,000 are eligible for the wage credit (although only the first \$15,000 of wages is eligible for the credit). The wage credit is available with respect to a qualified full-time or part-time employee (employed for at least 90 days), regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the D.C. Zone may claim the wage credit, regardless of whether the employer meets the definition of a “D.C. Zone business.”²³

An employer’s deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.²⁴ Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer’s work opportunity tax

²³ However, the wage credit is not available for wages paid in connection with certain business activities described in section 144(c)(6)(B) or certain farming activities. In addition, wages are not eligible for the wage credit if paid to (1) a person who owns more than five percent of the stock (or capital or profits interests) of the employer, (2) certain relatives of the employer, or (3) if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business.

²⁴ Sec. 280C(a).

credit under section 51 or the welfare-to-work credit under section 51A.²⁵ In addition, the \$15,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.²⁶ The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.²⁷

Section 179 expensing

In general, a D.C. Zone business is allowed an additional \$35,000 of section 179 expensing for qualifying property placed in service by a D.C. Zone business.²⁸ The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified zone property placed in service during the year by the taxpayer exceeds \$200,000 (\$400,000 for taxable years beginning after 2002 and before 2010). The term “qualified zone property” is defined as depreciable tangible property (including buildings), provided that (1) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (2) the original use of the property in the D.C. Zone commences with the taxpayer, and (3) substantially all of the use of the property is in the D.C. Zone in the active conduct of a trade or business by the taxpayer.²⁹ Special rules are provided in the case of property that is substantially renovated by the taxpayer.

Tax-exempt financing

A qualified D.C. Zone business is permitted to borrow proceeds from tax-exempt qualified enterprise zone facility bonds (as defined in section 1394) issued by the District of Columbia.³⁰ Such bonds are subject to the District of Columbia’s annual private activity bond volume limitation. Generally, qualified enterprise zone facility bonds for the District of Columbia are bonds 95 percent or more of the net proceeds of which are used to finance certain facilities within the D.C. Zone. The aggregate face amount of all outstanding qualified enterprise zone facility bonds per qualified D.C. Zone business may not exceed \$15 million and may be issued only while the D.C. Zone designation is in effect.

Zero-percent capital gains

A zero-percent capital gains rate applies to capital gains from the sale of certain qualified D.C. Zone assets held for more than five years.³¹ In general, a qualified “D.C. Zone asset”

²⁵ Secs. 1400H(a), 1396(c)(3)(A) and 51A(d)(2).

²⁶ Secs. 1400H(a), 1396(c)(3)(B) and 51A(d)(2).

²⁷ Sec. 38(c)(2).

²⁸ Sec. 1397A.

²⁹ Sec. 1397D.

³⁰ Sec. 1400A.

³¹ Sec. 1400B.

means stock or partnership interests held in, or tangible property held by, a D.C. Zone business. For purposes of the zero-percent capital gains rate, the D.C. Enterprise Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than 10 percent.

In general, gain eligible for the zero-percent tax rate means gain from the sale or exchange of a qualified D.C. Zone asset that is (1) a capital asset or property used in the trade or business as defined in section 1231(b), and (2) acquired before January 1, 2006. Gain that is attributable to real property, or to intangible assets, qualifies for the zero-percent rate, provided that such real property or intangible asset is an integral part of a qualified D.C. Zone business.³² However, no gain attributable to periods before January 1, 1998, and after December 31, 2010, is qualified capital gain.

District of Columbia homebuyer tax credit

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to \$5,000 of the amount of the purchase price. The \$5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of \$2,500 each. The credit phases out for individual taxpayers with adjusted gross income between \$70,000 and \$90,000 (\$110,000-\$130,000 for joint filers). For purposes of eligibility, “first-time homebuyer” means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one-year period ending on the date of the purchase of the residence to which the credit applies. The credit expired for purchases after December 31, 2005.³³

Explanation of Provision

The provision extends the designation of the D.C. Zone for two years (through December 31, 2007), thus extending the wage credit and section 179 expensing for two years.

The provision extends the tax-exempt financing authority for two years, applying to bonds issued during the period beginning on January 1, 1998, and ending on December 31, 2007.

The provision extends the zero-percent capital gains rate applicable to capital gains from the sale of certain qualified D.C. Zone assets for two years.

The provision extends the first-time homebuyer credit for two years, through December 31, 2007.

³² However, sole proprietorships and other taxpayers selling assets directly cannot claim the zero-percent rate on capital gain from the sale of any intangible property (i.e., the integrally related test does not apply).

³³ Sec. 1400C(i).

Effective date.—The provision is effective for periods beginning after, bonds issued after, acquisitions after, and property purchased after December 31, 2005.

11. Indian employment tax credit (sec. 45A of the Code)

Present Law

In general, a credit against income tax liability is allowed to employers for the first \$20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the employer with respect to certain employees (sec. 45A). The credit is equal to 20 percent of the excess of eligible employee qualified wages and health insurance costs during the current year over the amount of such wages and costs incurred by the employer during 1993. The credit is an incremental credit, such that an employer's current-year qualified wages and qualified employee health insurance costs (up to \$20,000 per employee) are eligible for the credit only to the extent that the sum of such costs exceeds the sum of comparable costs paid during 1993. No deduction is allowed for the portion of the wages equal to the amount of the credit.

Qualified wages means wages paid or incurred by an employer for services performed by a qualified employee. A qualified employee means any employee who is an enrolled member of an Indian tribe or the spouse of an enrolled member of an Indian tribe, who performs substantially all of the services within an Indian reservation, and whose principal place of abode while performing such services is on or near the reservation in which the services are performed. An "Indian reservation" is a reservation as defined in section 3(d) of the Indian Financing Act of 1974 or section 4(1) of the Indian Child Welfare Act of 1978. For purposes of the preceding sentence, section 3(d) is applied by treating "former Indian reservations in Oklahoma" as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).

An employee is not treated as a qualified employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to such employee during the taxable year exceeds an amount determined at an annual rate of \$30,000 (which after adjusted for inflation after 1993 is currently \$35,000). In addition, an employee will not be treated as a qualified employee under certain specific circumstances, such as where the employee is related to the employer (in the case of an individual employer) or to one of the employer's shareholders, partners, or grantors. Similarly, an employee will not be treated as a qualified employee where the employee has more than a 5 percent ownership interest in the employer. Finally, an employee will not be considered a qualified employee to the extent the employee's services relate to gaming activities or are performed in a building housing such activities.

The wage credit is available for wages paid or incurred on or after January 1, 1994, in taxable years that begin before January 1, 2006.

Explanation of Provision

The provision extends for two years the present-law employment credit provision (through taxable years beginning on or before December 31, 2007).

Effective date.—The provision is effective for taxable years beginning after December 31, 2005.

12. Accelerated depreciation for business property on Indian reservations (sec. 168 of the Code)

Present Law

With respect to certain property used in connection with the conduct of a trade or business within an Indian reservation, depreciation deductions under section 168(j) are determined using the following recovery periods:

3-year property	2 years
5-year property	3 years
7-year property	4 years
10-year property	6 years
15-year property	9 years
20-year property	12 years
Nonresidential real property	22 years

“Qualified Indian reservation property” eligible for accelerated depreciation includes property which is (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation, (2) not used or located outside the reservation on a regular basis, (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer (within the meaning of section 465(b)(3)(C)), and (4) described in the recovery-period table above. In addition, property is not “qualified Indian reservation property” if it is placed in service for purposes of conducting gaming activities. Certain “qualified infrastructure property” may be eligible for the accelerated depreciation even if located outside an Indian reservation, provided that the purpose of such property is to connect with qualified infrastructure property located within the reservation (e.g., roads, power lines, water systems, railroad spurs, and communications facilities).

An “Indian reservation” means a reservation as defined in section 3(d) of the Indian Financing Act of 1974 or section 4(1) of the Indian Child Welfare Act of 1978. For purposes of the preceding sentence, section 3(d) is applied by treating “former Indian reservations in Oklahoma” as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax. The accelerated depreciation for Indian reservations is available

with respect to property placed in service on or after January 1, 1994, and before January 1, 2006.

Explanation of Provision

The provision extends for two years the present-law incentive relating to depreciation of qualified Indian reservation property (to apply to property placed in service through December 31, 2007).

Effective date.—The provision applies to property placed in service after December 31, 2005.

13. Fifteen-year straight-line cost recovery for qualified leasehold improvements and qualified restaurant property (sec. 168 of the Code)

Present Law

In general

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property (sec. 168). The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

Depreciation of leasehold improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease. This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service. If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service. However, exceptions exist for certain qualified leasehold improvements and certain qualified restaurant property.

Qualified leasehold improvement property

Section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2006. Qualified leasehold

improvement property is recovered using the straight-line method. Leasehold improvements placed in service in 2006 and later will be subject to the general rules described above.

Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building. However, if a lessor makes an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

Qualified restaurant property

Section 168(e)(3)(E)(v) provides a statutory 15-year recovery period for qualified restaurant property placed in service before January 1, 2006. For purposes of the provision, qualified restaurant property means any improvement to a building if such improvement is placed in service more than three years after the date such building was first placed in service and more than 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals. Qualified restaurant property is recovered using the straight-line method.

Explanation of Provision

The present-law provisions are extended for two years (through December 31, 2007). In addition, for property placed in service after the date of enactment, the three-year rule for restaurant property is repealed. Thus, new restaurant property and restaurant improvements within the first three years also qualify for the fifteen-year recovery period.

Effective date.—The provision applies to property placed in service after December 31, 2005, except for the repeal of the three-year rule for restaurant property, which applies for property placed in service after the date of enactment.

14. Suspend limitation on rate of rum excise tax cover over to Puerto Rico and Virgin Islands (sec. 7652 of the Code)

Present Law

A \$13.50 per proof gallon³⁴ excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States.³⁵ The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).³⁶

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.³⁷ The amount of the cover over is limited under Code section 7652(f) to \$10.50 per proof gallon (\$13.25 per proof gallon during the period July 1, 1999 through December 31, 2005).

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.³⁸ Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.³⁹ All of the amounts covered over are subject to the limitation.

Explanation of Provision

The provision temporarily suspends the \$10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. Under the provision, the cover over amount of \$13.25 per proof gallon is extended for rum brought into the United States after December 31, 2005 and before January 1, 2008. After December 31, 2007, the cover over amount reverts to \$10.50 per proof gallon.

³⁴ A proof gallon is a liquid gallon consisting of 50 percent alcohol. See sec. 5002(a)(10) and (11).

³⁵ Sec. 5001(a)(1).

³⁶ Secs. 5062(b), 7653(b) and (c).

³⁷ Secs. 7652(a)(3), (b)(3), and (e)(1). One percent of the amount of excise tax collected from imports into the United States of articles produced in the Virgin Islands is retained by the United States under section 7652(b)(3).

³⁸ Sec. 7652(e)(2).

³⁹ Secs. 7652(a)(3), (b)(3), and (e)(1).

Effective date.—The changes in the cover over rate are effective for articles brought into the United States after December 31, 2005.

15. Parity in the application of certain limits to mental health benefits (sec. 9812 of the Code)

Present Law

The Code, the Employee Retirement Income Security Act of 1974 (“ERISA”) and the Public Health Service Act (“PHSA”) contain provisions under which group health plans that provide both medical and surgical benefits and mental health benefits cannot impose aggregate lifetime or annual dollar limits on mental health benefits that are not imposed on substantially all medical and surgical benefits (“mental health parity requirements”). In the case of a group health plan which provides benefits for mental health, the mental health parity requirements do not affect the terms and conditions (including cost sharing, limits on numbers of visits or days of coverage, and requirements relating to medical necessity) relating to the amount, duration, or scope of mental health benefits under the plan, except as specifically provided in regard to parity in the imposition of aggregate lifetime limits and annual limits.

The Code imposes an excise tax on group health plans which fail to meet the mental health parity requirements. The excise tax is equal to \$100 per day during the period of noncompliance and is generally imposed on the employer sponsoring the plan if the plan fails to meet the requirements. The maximum tax that can be imposed during a taxable year cannot exceed the lesser of 10 percent of the employer’s group health plan expenses for the prior year or \$500,000. No tax is imposed if the Secretary determines that the employer did not know, and in exercising reasonable diligence would not have known, that the failure existed.

The mental health parity requirements do not apply to group health plans of small employers nor do they apply if their application results in an increase in the cost under a group health plan of at least one percent. Further, the mental health parity requirements do not require group health plans to provide mental health benefits.

The Code, ERISA and PHSA mental health parity requirements are scheduled to expire with respect to benefits for services furnished after December 31, 2006.

Explanation of Provision

The provision extends the present-law Code excise tax for failure to comply with the mental health parity requirements through December 31, 2007. It also extends the ERISA and PHSA requirements through December 31, 2007.

Effective date.—The provision is effective on the date of enactment.

16. Expand charitable contribution allowed for scientific property used for research and expand and extend the charitable contribution allowed computer technology and equipment (sec. 170 of the Code)

Present Law

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.⁴⁰

Under present law, a taxpayer's deduction for charitable contributions of scientific property used for research and for contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a "qualified research contribution" or a "qualified computer contribution."⁴¹ This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. The enhanced deduction for qualified computer contributions expired for any contribution made during any taxable year beginning after December 31, 2005.

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

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

⁴⁰ Sec. 170(e)(1).

⁴¹ Secs. 170(e)(4) and 170(e)(6).

substantially completed.⁴² The original use of the property must be by the donor or the donee,⁴³ and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed by the taxpayer, the rules applicable to qualified research contributions apply. Contributions may be made to private foundations under certain conditions.⁴⁴

Explanation of Provision

The provision extends the present-law provision relating to the enhanced deduction for computer technology and equipment for two years to apply to contributions made during any taxable year beginning after December 31, 2005, and before January 1, 2008.

Under the provision, property assembled by the taxpayer, in addition to property constructed by the taxpayer, is eligible for either the enhanced deduction relating to computer technology and equipment or to scientific property used for research. It is not intended that old or used components assembled by the taxpayer into scientific property or computer technology or equipment are eligible for the enhanced deduction.

Effective date.—The provision is effective for taxable years beginning after December 31, 2005.

17. Availability of Archer medical savings accounts (sec. 220 of the Code)

Present Law

Archer medical savings accounts

In general

Within limits, contributions to an Archer medical savings account ("Archer MSA") are deductible in determining adjusted gross income if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an Archer MSA are not currently taxable. Distributions from an Archer MSA for medical expenses are not includible in gross income. Distributions not used for medical expenses are includible in gross income. In addition,

⁴² If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

⁴³ This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

⁴⁴ Sec. 170(e)(6)(C).

distributions not used for medical expenses are subject to an additional 15-percent tax unless the distribution is made after age 65, death, or disability.

Eligible individuals

Archer MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high deductible health plan. An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year. An individual is not eligible for an Archer MSA if he or she is covered under any other health plan in addition to the high deductible plan.

Tax treatment of and limits on contributions

Individual contributions to an Archer MSA are deductible (within limits) in determining adjusted gross income (i.e., “above-the-line”). In addition, employer contributions are excludable from gross income and wages for employment tax purposes (within the same limits), except that this exclusion does not apply to contributions made through a cafeteria plan. In the case of an employee, contributions can be made to an Archer MSA either by the individual or by the individual’s employer.

The maximum annual contribution that can be made to an Archer MSA for a year is 65 percent of the deductible under the high deductible plan in the case of individual coverage and 75 percent of the deductible in the case of family coverage.

Definition of high deductible plan

A high deductible plan is a health plan with an annual deductible of at least \$1,800 and no more than \$2,700 in the case of individual coverage and at least \$3,650 and no more than \$5,450 in the case of family coverage (for 2006). In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must be no more than \$3,650 in the case of individual coverage and no more than \$6,650 in the case of family coverage (for 2006). A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for certain permitted coverage. In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

Cap on taxpayers utilizing Archer MSAs and expiration of pilot program

The number of taxpayers benefiting annually from an Archer MSA contribution is limited to a threshold level (generally 750,000 taxpayers). The number of Archer MSAs established has not exceeded the threshold level.

After 2005, no new contributions may be made to Archer MSAs except by or on behalf of individuals who previously made (or had made on their behalf) Archer MSA contributions and employees who are employed by a participating employer.

Trustees of Archer MSAs are generally required to make reports to the Treasury by August 1 regarding Archer MSAs established by July 1 of that year. If the threshold level is reached in a year, the Secretary is required to make and publish such determination by October 1 of such year.

Health savings accounts

Health savings accounts (“HSAs”) were enacted by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003. Like Archer MSAs, an HSA is a tax-exempt trust or custodial account to which tax-deductible contributions may be made by individuals with a high deductible health plan. HSAs provide tax benefits similar to, but more favorable than, those provide by Archer MSAs. HSAs were established on a permanent basis.

Explanation of Provision

The provision extends for two years the present-law Archer MSA provisions (through December 31, 2007).

The report required by Archer MSA trustees is treated as timely filed if made before the close of the 90-day period beginning on the date of enactment. The determination and publication whether the threshold level has been exceeded is treated as timely if made before the close of the 120-day period beginning on the date of enactment.

Effective date.—The provision is effective on the date of enactment.

18. Taxable income limit on percentage depletion for oil and natural gas produced from marginal properties (sec. 613A of the Code)

Present Law

The Code permits taxpayers to recover their investments in oil and gas wells through depletion deductions. Two methods of depletion are currently allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method. Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer’s basis in the property.

The Code generally limits the percentage depletion method for oil and gas properties to independent producers and royalty owners. Generally, under the percentage depletion method, 15 percent of the taxpayer’s gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year. The amount deducted generally may not exceed 100 percent of the taxable income from that property in any year. For marginal production, the 100-percent taxable income limitation has been suspended for taxable years beginning after December 31, 1997, and before January 1, 2006.

Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property substantially all of the production from which during the calendar year is heavy oil. Stripper well property is property from which the average daily production is 15 barrel equivalents or less, determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells. Heavy oil is domestic crude oil with a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Fahrenheit).

Explanation of Provision

The provision extends for two years the present-law taxable income limitation suspension provision for marginal production (through taxable years beginning on or before December 31, 2007).

Effective date.—The provision applies to taxable years beginning after December 31, 2005.

19. Economic development credit with respect to American Samoa

Present Law

In general

Certain domestic corporations with business operations in the U.S. possessions are eligible for the possession tax credit.⁴⁵ This credit offsets the U.S. tax imposed on certain income related to operations in the U.S. possessions.⁴⁶ For purposes of the credit, possessions include, among other places, American Samoa. Subject to certain limitations described below, the amount of the possession tax credit allowed to any domestic corporation equals the portion of that corporation's U.S. tax that is attributable to the corporation's non-U.S. source taxable income from (1) the active conduct of a trade or business within a U.S. possession, (2) the sale or exchange of substantially all of the assets that were used in such a trade or business, or (3) certain possessions investment.⁴⁷ No deduction or foreign tax credit is allowed for any possessions or foreign tax paid or accrued with respect to taxable income that is taken into account in computing the credit under section 936.⁴⁸ The section 936 credit expires for taxable years beginning after December 31, 2005.

⁴⁵ Secs. 27(b), 936.

⁴⁶ Domestic corporations with activities in Puerto Rico are eligible for the section 30A economic activity credit. That credit is calculated under the rules set forth in section 936.

⁴⁷ Under phase-out rules described below, investment only in Guam, American Samoa, and the Northern Mariana Islands (and not in other possessions) now may give rise to income eligible for the section 936 credit.

⁴⁸ Sec. 936(c).

To qualify for the possession tax credit for a taxable year, a domestic corporation must satisfy two conditions. First, the corporation must derive at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year from sources within a possession. Second, the corporation must derive at least 75 percent of its gross income for that same period from the active conduct of a possession business.

The possession tax credit is available only to a corporation that qualifies as an existing credit claimant. The determination of whether a corporation is an existing credit claimant is made separately for each possession. The possession tax credit is computed separately for each possession with respect to which the corporation is an existing credit claimant, and the credit is subject to either an economic activity-based limitation or an income-based limit.

Qualification as existing credit claimant

A corporation is an existing credit claimant with respect to a possession if (1) the corporation was engaged in the active conduct of a trade or business within the possession on October 13, 1995, and (2) the corporation elected the benefits of the possession tax credit in an election in effect for its taxable year that included October 13, 1995.⁴⁹ A corporation that adds a substantial new line of business (other than in a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) ceases to be an existing credit claimant as of the close of the taxable year ending before the date on which that new line of business is added.

Economic activity-based limit

Under the economic activity-based limit, the amount of the credit determined under the rules described above may not exceed an amount equal to the sum of (1) 60 percent of the taxpayer's qualified possession wages and allocable employee fringe benefit expenses, (2) 15 percent of depreciation allowances with respect to short-life qualified tangible property, plus 40 percent of depreciation allowances with respect to medium-life qualified tangible property, plus 65 percent of depreciation allowances with respect to long-life qualified tangible property, and (3) in certain cases, a portion of the taxpayer's possession income taxes.

Income-based limit

As an alternative to the economic activity-based limit, a taxpayer may elect to apply a limit equal to the applicable percentage of the credit that would otherwise be allowable with respect to possession business income; the applicable percentage currently is 40 percent.

⁴⁹ A corporation will qualify as an existing credit claimant if it acquired all the assets of a trade or business of a corporation that (1) actively conducted that trade or business in a possession on October 13, 1995, and (2) had elected the benefits of the possession tax credit in an election in effect for the taxable year that included October 13, 1995.

Repeal and phase out

In 1996, the section 936 credit was repealed for new claimants for taxable years beginning after 1995 and was phased out for existing credit claimants over a period including taxable years beginning before 2006. The amount of the available credit during the phase-out period generally is reduced by special limitation rules. These phase-out period limitation rules do not apply to the credit available to existing credit claimants for income from activities in Guam, American Samoa, and the Northern Mariana Islands. As described previously, the section 936 credit is repealed for all possessions, including Guam, American Samoa, and the Northern Mariana Islands, for all taxable years beginning after 2005.

Explanation of Provision

Under the provision, a domestic corporation that is an existing credit claimant with respect to American Samoa and that elected the application of section 936 for its last taxable year beginning before January 1, 2006 is allowed, for two taxable years, a credit based on the economic activity-based limitation rules described above. The credit is not part of the Code but is computed based on the rules secs. 30A and 936.

The amount of the credit allowed to a qualifying domestic corporation under the provision is equal to the sum of the amounts used in computing the corporation's economic activity-based limitation (described above in the present law section) with respect to American Samoa, except that no credit is allowed for the amount of any American Samoa income taxes. Thus, for any qualifying corporation the amount of the credit equals the sum of (1) 60 percent of the corporation's qualified American Samoa wages and allocable employee fringe benefit expenses and (2) 15 percent of the corporation's depreciation allowances with respect to short-life qualified American Samoa tangible property, plus 40 percent of the corporation's depreciation allowances with respect to medium-life qualified American Samoa tangible property, plus 65 percent of the corporation's depreciation allowances with respect to long-life qualified American Samoa tangible property.

The present-law section 936(c) rule denying a credit or deduction for any possessions or foreign tax paid with respect to taxable income taken into account in computing the credit under section 936 does not apply with respect to the credit allowed by the provision.

The two-year credit allowed by the provision is intended to provide additional time for the development of a comprehensive, long-term economic policy toward American Samoa. It is expected that in developing a long-term policy, non-tax policy alternatives should be carefully considered. It is expected that long-term policy toward the possessions should take into account the unique circumstances in each possession.

Effective date.—The provision is effective for the first two taxable years of a corporation which begin after December 31, 2005 and before January 1, 2008.

20. Restructure New York Liberty Zone tax incentives (sec. 1400L of the Code)

Present Law

In general

Present law includes a number of incentives to invest in property located in the New York Liberty Zone (“NYLZ”), which is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York. These incentives were enacted following the terrorist attack in New York City on September 11, 2001.⁵⁰

Special depreciation allowance for qualified New York Liberty Zone property

Section 1400L(b) allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified NYLZ property.⁵¹ In order to qualify, property generally must be placed in service on or before December 31, 2006 (December 31, 2009 in the case of nonresidential real property and residential rental property).

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be property to which the general rules of the Modified Accelerated Cost Recovery System (“MACRS”)⁵² apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) certain nonresidential real property and residential rental property, or (4) computer software other than computer software covered by section 197. A special rule precludes the additional first-year depreciation under this provision for (1) qualified NYLZ

⁵⁰ In addition to the NYLZ provisions described above, other NYLZ incentives are provided: (1) \$8 billion of tax-exempt private activity bond financing for certain nonresidential real property, residential rental property and public utility property is authorized to be issued after March 9, 2002, and before January 1, 2010; and (2) \$9 billion of additional tax-exempt advance refunding bonds is available after March 9, 2002, and before January 1, 2006, with respect to certain State or local bonds outstanding on September 11, 2001.

⁵¹ The amount of the additional first-year depreciation deduction is not affected by a short taxable year.

⁵² A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.

leasehold improvement property⁵³ and (2) property eligible for the additional first-year depreciation deduction under section 168(k) (i.e., property is eligible for only one 30 percent additional first-year depreciation). Second, substantially all of the use of such property must be in the NYLZ. Third, the original use of the property in the NYLZ must commence with the taxpayer on or after September 11, 2001. Finally, the property must be acquired by purchase⁵⁴ by the taxpayer after September 10, 2001 and placed in service on or before December 31, 2006. For qualifying nonresidential real property and residential rental property the property must be placed in service on or before December 31, 2009 in lieu of December 31, 2006. Property will not qualify if a binding written contract for the acquisition of such property was in effect before September 11, 2001.⁵⁵

Nonresidential real property and residential rental property are eligible for the additional first-year depreciation only to the extent such property rehabilitates real property damaged, or replaces real property destroyed or condemned as a result of the terrorist attacks of September 11, 2001.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies for the additional first-year depreciation deduction if the taxpayer begins the manufacture, construction, or production of the property after September 10, 2001, and the property is placed in service on or before December 31, 2006⁵⁶ (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Depreciation of New York Liberty Zone leasehold improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease.⁵⁷ This rule applies regardless of whether the lessor or the

⁵³ Qualified NYLZ leasehold improvement property is defined in another provision. Leasehold improvements that do not satisfy the requirements to be treated as “qualified NYLZ leasehold improvement property” may be eligible for the 30 percent additional first-year depreciation deduction (assuming all other conditions are met).

⁵⁴ For purposes of this provision, purchase is defined as under section 179(d).

⁵⁵ Property is not precluded from qualifying for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to September 11, 2001.

⁵⁶ December 31, 2009 with respect to qualified nonresidential real property and residential rental property.

⁵⁷ Sec. 168(i)(8). The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System (“ACRS”) to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Tax Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with

lessee places the leasehold improvements in service.⁵⁸ If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement is placed in service.⁵⁹

A special rule exists for qualified NYLZ leasehold improvement property, which is recovered over five years using the straight-line method. The term qualified NYLZ leasehold improvement property means property defined in section 168(e)(6) that is acquired and placed in service after September 10, 2001, and before January 1, 2007 (and not subject to a binding contract on September 10, 2001), in the NYLZ. For purposes of the alternative depreciation system, the property is assigned a nine-year recovery period. A taxpayer may elect out of the 5-year (and 9-year) recovery period for qualified NYLZ leasehold improvement property.

Increased section 179 expensing for qualified New York Liberty Zone property

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct the cost of qualifying property. For taxable years beginning in 2003 through 2009, a taxpayer may deduct up to \$100,000 of the cost of qualifying property placed in service for the taxable year. In general, qualifying property for this purpose is defined as depreciable tangible personal property (and certain computer software) that is purchased for use in the active conduct of a trade or business. The \$100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$400,000. The \$100,000 and \$400,000 amounts are indexed for inflation.

For taxable years beginning in 2010 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. In general, qualifying property for this purpose is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The Tax Reform Act of 1986 also denied the use of component depreciation under MACRS.

⁵⁸ Former sections 168(f)(6) and 178 provided that, in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. The Tax Reform Act of 1986 repealed these provisions.

⁵⁹ Secs. 168(b)(3), (c), (d)(2), and (i)(6). If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods, accelerated methods, and conventions applicable to such property. The determination of whether improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a “structural component” of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, e.g., *Metro National Corp v. Commissioner*, 52 TCM (CCH) 1440 (1987); *King Radio Corp Inc. v. U.S.*, 486 F.2d 1091 (10th Cir. 1973); *Mallinckrodt, Inc. v. Commissioner*, 778 F.2d 402 (8th Cir. 1985) (with respect to various leasehold improvements).

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

The amount a taxpayer can deduct under section 179 is increased for qualifying property used in the NYLZ. Specifically, the maximum dollar amount that may be deducted under section 179 is increased by the lesser of (1) \$35,000 or (2) the cost of qualifying property placed in service during the taxable year. This amount is in addition to the amount otherwise deductible under section 179.

Qualifying property for purposes of the NYLZ provision means section 179 property⁶⁰ purchased and placed in service by the taxpayer after September 10, 2001 and before January 1, 2007, where (1) substantially all of the use of such property is in the NYLZ in the active conduct of a trade or business by the taxpayer in the NYLZ, and (2) the original use of which in the NYLZ commences with the taxpayer after September 10, 2001.⁶¹

The phase-out range for the section 179 deduction attributable to NYLZ property is applied by taking into account only 50 percent of the cost of NYLZ property that is section 179 property. Also, no general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

The provision is effective for property placed in service after September 10, 2001 and before January 1, 2007.

Extended replacement period for New York Liberty Zone involuntary conversions

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period (the “replacement period”) property similar or related in service or use (section 1033). If the taxpayer does not replace the converted property with property similar or related in service or use, then gain generally is recognized. If the taxpayer elects to apply the rules of section 1033, gain on the converted property is recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property. In general, the replacement period begins with the date of the disposition of the converted property and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized.⁶² The replacement period is extended

⁶⁰ As defined in sec. 179(d)(1).

⁶¹ See Rev. Proc. 2002-33, 2002-20 I.R.B. 963 (May 20, 2002), for procedures on claiming the increased section 179 expensing deduction by taxpayers who filed their tax returns before June 1, 2002.

⁶² Section 1033(a)(2)(B).

to three years if the converted property is real property held for the productive use in a trade or business or for investment.⁶³

The replacement period is extended to five years with respect to property that was involuntarily converted within the NYLZ as a result of the terrorist attacks that occurred on September 11, 2001. However, the five-year period is available only if substantially all of the use of the replacement property is in New York City. In all other cases, the present-law replacement period rules continue to apply.

Explanation of Provision

Repeal of certain NYLZ incentives

The provision repeals three NYLZ incentives relating to the additional first-year depreciation allowance of 30 percent, the five-year depreciation of leasehold improvements, and the additional section 179 expensing. The extended replacement period for involuntary conversions is not repealed.⁶⁴

Creation of New York Liberty Zone Tax Credits

The provision provides a credit against tax imposed for any payroll period by section 3402 (related to withholding for wages paid) for which a New York Liberty Zone governmental unit is liable under section 3403. The credit is equal to such portion of the qualifying project expenditure amounts allocated to the governmental unit for the calendar year that such governmental unit allocates to such period. The amount of the credit allowed for any payroll period shall be treated as a payment to the Secretary on the day on which the wages were paid to the employee, but only to the extent the governmental unit actually deducted and withheld such wages for the applicable period. A New York Liberty Zone governmental unit is the State of New York, the City of New York, or any agency or instrumentality of such State or city.

Qualifying project expenditure amount means, with respect to any calendar year, the sum of (1) the total expenditures paid or incurred during such calendar year by all New York Liberty Zone governmental units and the Port Authority of New York and New Jersey for any portion of qualifying projects located wholly within the City of New York, New York, and (2) any such expenditures paid or incurred in any preceding calendar year beginning after the date of enactment of this provision and not previously allocated.

A qualifying project is any transportation infrastructure project, including highways, mass transit systems, railroads, airports, ports, and waterways, in or connecting with the New York Liberty Zone, which is designated as a qualifying project by the Governor of the State of New York and the Mayor of the City of New York.

⁶³ Section 1033(g)(4).

⁶⁴ The provision also does not change the present-law rules relating to certain NYLZ private activity bond financing and additional advance refunding bonds.

The Governor of the State of New York and the Mayor of the City of New York, New York, are to jointly allocate to each New York Liberty Zone governmental unit the portion of the qualifying expenditure amount which may be taken into account by such governmental unit to determine the credit for any calendar year in the credit period. The credit period is the 15 year period beginning on January 1, 2007. Aggregate amounts allocated may not exceed \$1.75 billion during the credit period. There is also an annual limit on allocations equal to (1) \$100 million for years 2007 to 2016; \$200 million for years 2017 or 2018; \$150 million for year 2019; and \$100 million for years 2020 or 2021; \$0 for 2022 and thereafter; plus (2) any amounts in (1) that were authorized to be allocated for prior calendar years in the credit period but not so allocated.

If amounts allocated to a New York Liberty Zone governmental unit exceed the aggregate taxes for which such unit is liable under section 3403, the excess may be carried to the succeeding calendar year and added to the allocation for that calendar year. No amounts may be carried to a calendar year after 2026, and no credits are allowed after 2026. If a New York Liberty Zone governmental unit does not use an amount allocated to it within the time prescribed by the Governor of the State of New York and the Mayor of the City of New York, such amounts will be treated as if never allocated, and thus they may be reallocated by the Governor and Mayor.

If at the close of the credit period aggregate allocated amounts are less than \$1.75 billion, the Governor and Mayor may allocate such shortfall in the 5-yr period after the credit period, provided sufficient qualifying project expenditures have been made during the credit period or the 5-yr period after the credit period.

Under the provision, any expenditure for a qualifying project taken into account for purposes of the credit shall be considered State and local funds for the purpose of any Federal program.

The Governor of the State of New York and the Mayor of the City of New York must jointly submit to the Secretary an annual report that certifies the qualifying project expenditure amounts for the calendar year and the amount allocated to each New York Liberty Zone governmental unit and any other such information as the Secretary may require.

Effective date.—The provision is effective on the date of enactment, with an exception for property subject to a written binding contract in effect on the date of enactment which is placed in service prior to the original sunset dates under present law. The extended replacement period for involuntarily converted property ends on the earlier of (1) the date of enactment or (2) the last day of the five-year period specified in the Jobs Creation and Worker Assistance Act of 2002 (“JCWAA”).⁶⁵

⁶⁵ Pub. Law No. 107-147, sec. 301 (2002).

21. Extension of placed-in-service deadline for certain Gulf Opportunity Zone property (sec. 1400N of the Code)

Present Law

In general

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system (“MACRS”). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Gulf Opportunity Zone property

Present law provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified Gulf Opportunity Zone⁶⁶ property. In order to qualify, property generally must be placed in service on or before December 31, 2007 (December 31, 2008 in the case of nonresidential real property and residential rental property).

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under section 162 or subject to capitalization under section 263 or section 263A. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, the provision provides that there is no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer’s alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be property (1) to which the general rules of the Modified Accelerated Cost Recovery System (“MACRS”) apply with an

⁶⁶ The “Gulf Opportunity Zone” is defined as that portion of the Hurricane Katrina Disaster Area determined by the President to warrant individual or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina. The term “Hurricane Katrina disaster area” means an area with respect to which a major disaster has been declared by the President before September 14, 2005, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.

applicable recovery period of 20 years or less, (2) computer software other than computer software covered by section 197, (3) water utility property (as defined in section 168(e)(5)), (4) certain leasehold improvement property, or (5) certain nonresidential real property and residential rental property. Second, substantially all of the use of such property must be in the Gulf Opportunity Zone and in the active conduct of a trade or business by the taxpayer in the Gulf Opportunity Zone. Third, the original use of the property in the Gulf Opportunity Zone must commence with the taxpayer on or after August 28, 2005. (Thus, used property may constitute qualified property so long as it has not previously been used within the Gulf Opportunity Zone. In addition, it is intended that additional capital expenditures incurred to recondition or rebuild property the original use of which in the Gulf Opportunity Zone began with the taxpayer would satisfy the “original use” requirement. See Treasury Regulation 1.48-2 Example 5.) Finally, the property must be acquired by purchase (as defined under section 179(d)) by the taxpayer on or after August 28, 2005 and placed in service on or before December 31, 2007. For qualifying nonresidential real property and residential rental property, the property must be placed in service on or before December 31, 2008, in lieu of December 31, 2007. Property does not qualify if a binding written contract for the acquisition of such property was in effect before August 28, 2005. However, property is not precluded from qualifying for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to August 28, 2005.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction, or production of the property on or after August 28, 2005, and the property is placed in service on or before December 31, 2007 (and all other requirements are met). In the case of qualified nonresidential real property and residential rental property, the property must be placed in service on or before December 31, 2008. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Under a special rule, property any portion of which is financed with the proceeds of a tax-exempt obligation under section 103 is not eligible for the additional first-year depreciation deduction. Recapture rules apply under the provision if the property ceases to be qualified Gulf Opportunity Zone property.

Explanation of Provision

The provision extends the placed-in-service deadline for specified Gulf Opportunity Zone extension property to qualify for the additional first-year depreciation deduction.⁶⁷ Specified Gulf Opportunity Zone extension property is defined as property substantially all the use of which is in one or more specified portions of the Gulf Opportunity Zone and which is either: (1) nonresidential real property or residential rental property which is placed in service by the

⁶⁷ The extension of the placed-in-service deadline does not apply for purposes of the increased section 179 expensing limit available to Gulf Opportunity Zone property.

taxpayer on or before December 31, 2009, or (2) in the case of a taxpayer who places in service a building described in (1), property described in section 168(k)(2)(A)(i)⁶⁸ if substantially all the use of such property is in such building and such property is placed in service within 90 days of the date the building is placed in service.

The specified portions of the Gulf Opportunity Zone are defined as those portions of the Gulf Opportunity Zone which are in a county or parish which is identified by the Secretary of the Treasury (or his delegate) as being a county or parish in which hurricanes occurring in 2005 damaged (in the aggregate) more than 40 percent of the housing units in such county or parish which were occupied (determined according to the 2000 Census.)⁶⁹

Effective date.—The provision applies as if included in section 101 of the Gulf Opportunity Zone Act of 2005⁷⁰ (“GOZA”). Section 101 of GOZA is effective for property placed in service on or after August 28, 2005, in taxable years ending on or after such date.

22. Authority for undercover operations (sec. 7608 of the Code)

Present Law

IRS undercover operations are exempt from the otherwise applicable statutory restrictions controlling the use of Government funds (which generally provide that all receipts must be deposited in the general fund of the Treasury and all expenses paid out of appropriated funds). In general, the exemption permits the IRS to use proceeds from an undercover operation to pay additional expenses incurred in the undercover operation. The IRS is required to conduct a detailed financial audit of large undercover operations in which the IRS is using proceeds from such operations and to provide an annual audit report to the Congress on all such large undercover operations.

The provision was originally enacted in The Anti-Drug Abuse Act of 1988. The exemption originally expired on December 31, 1989, and was extended by the Comprehensive Crime Control Act of 1990 to December 31, 1991. There followed a gap of approximately four

⁶⁸ Generally, property described in section 168(k)(2)(A)(i) is (1) property to which the general rules of the Modified Accelerated Cost Recovery System (“MACRS”) apply with an applicable recovery period of 20 years or less, (2) computer software other than computer software covered by section 197, (3) water utility property (as defined in section 168(e)(5)), or (4) certain leasehold improvement property.

⁶⁹ The Office of the Federal Coordinator for Gulf Coast Rebuilding at the Department of Homeland Security, in cooperation with the Federal Emergency Management Agency, the Small Business Administration, and the Department of Housing and Urban Development, compiled data to assess the full extent of housing damage due to 2005 Hurricanes Katrina, Rita, and Wilma. The data was published on February 12, 2006 and is available at www.dhs.gov/dhspublic/interweb/assetlibrary/GulfCoast_HousingDamageEstimates_021206.pdf (last accessed July 21, 2006). It is intended that the Secretary or his delegate will make use of this data in identifying counties and parishes which qualify under the provision.

⁷⁰ Pub. L. No. 109-135 (2005).

and a half years during which the provision had lapsed. In the Taxpayer Bill of Rights II, the authority to use proceeds from undercover operations was extended for five years, through 2000. The Community Renewal Tax Relief Act of 2000 extended the authority of the IRS to use proceeds from undercover operations for an additional five years, through 2005. The Gulf Opportunity Zone Act of 2005 extended the authority through December 31, 2006.

Explanation of Provision

The provision extends for one year the present-law authority of the IRS to use proceeds from undercover operations to pay additional expenses incurred in conducting undercover operations (through December 31, 2007).

Effective date.—The provision is effective on the date of enactment.

23. Disclosures of Certain Tax Return Information

(a) Disclosure of tax information to facilitate combined employment tax reporting (sec. 6103 of the Code)

Present Law

Traditionally, Federal tax forms are filed with the Federal government and State tax forms are filed with individual States. This necessitates duplication of items common to both returns. The Code permits the IRS to disclose taxpayer identity information and signatures to any agency, body, or commission of any State for the purpose of carrying out with such agency, body or commission a combined Federal and State employment tax reporting program approved by the Secretary. The Federal disclosure restrictions, safeguard requirements, and criminal penalties for unauthorized disclosure and unauthorized inspection do not apply with respect to disclosures or inspections made pursuant to this authority. This provision expires after December 31, 2006.

Separately, under section 6103(c), the IRS may disclose a taxpayer's return or return information to such person or persons as the taxpayer may designate in a request for or consent to such disclosure. Pursuant to Treasury regulations, a taxpayer's participation in a combined return filing program between the IRS and a State agency, body or commission constitutes a consent to the disclosure by the IRS to the State agency of taxpayer identity information, signature and items of common data contained on the return. No disclosures may be made under this authority unless there are provisions of State law protecting the confidentiality of such items of common data.

Explanation of Provision

The provision extends for one year the present-law authority under section 6103(d)(5) for the combined employment tax reporting program (through December 31, 2007).

Effective date.—The provision applies to disclosures after December 31, 2006.

(b) Disclosure of return information regarding terrorist activities (sec. 6103 of the Code)

Present Law

In general

Section 6103 provides that returns and return information may not be disclosed by the IRS, other Federal employees, State employees, and certain others having access to the information except as provided in the Internal Revenue Code. Section 6103 contains a number of exceptions to this general rule of nondisclosure that authorize disclosure in specifically identified circumstances (including nontax criminal investigations) when certain conditions are satisfied.

Among the disclosures permitted under the Code is disclosure of returns and return information for purposes of investigating terrorist incidents, threats, or activities, and for analyzing intelligence concerning terrorist incidents, threats, or activities. The term “terrorist incident, threat, or activity” is statutorily defined to mean an incident, threat, or activity involving an act of domestic terrorism or international terrorism, as both of those terms are defined in the USA PATRIOT Act. In general, returns and taxpayer return information must be obtained pursuant to an ex parte court order. Return information, other than taxpayer return information, generally is available upon a written request meeting specific requirements. The IRS also is permitted to make limited disclosures of such information on its own initiative to the appropriate Federal law enforcement agency.

No disclosures may be made under these provisions after December 31, 2006.

Disclosure of returns and return information - by ex parte court order

Ex parte court orders sought by Federal law enforcement and Federal intelligence agencies

The Code permits, pursuant to an ex parte court order, the disclosure of returns and return information (including taxpayer return information) to certain officers and employees of a Federal law enforcement agency or Federal intelligence agency. These officers and employees are required to be personally and directly engaged in any investigation of, response to, or analysis of intelligence and counterintelligence information concerning any terrorist incident, threat, or activity. These officers and employees are permitted to use this information solely for their use in the investigation, response, or analysis, and in any judicial, administrative, or grand jury proceeding, pertaining to any such terrorist incident, threat, or activity.

The Attorney General, Deputy Attorney General, Associate Attorney General, an Assistant Attorney General, or a United States attorney, may authorize the application for the ex parte court order to be submitted to a Federal district court judge or magistrate. The Federal district court judge or magistrate would grant the order if based on the facts submitted he or she determines that: (1) there is reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity; and (2) the return or return information is sought exclusively for the

use in a Federal investigation, analysis, or proceeding concerning any terrorist incident, threat, or activity.

Special rule for ex parte court ordered disclosure initiated by the IRS

If the Secretary of Treasury possesses returns or return information that may be related to a terrorist incident, threat, or activity, the Secretary of the Treasury (or his delegate), may on his own initiative, authorize an application for an ex parte court order to permit disclosure to Federal law enforcement. In order to grant the order, the Federal district court judge or magistrate must determine that there is reasonable cause to believe, based upon information believed to be reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity. The information may be disclosed only to the extent necessary to apprise the appropriate Federal law enforcement agency responsible for investigating or responding to a terrorist incident, threat, or activity and for officers and employees of that agency to investigate or respond to such terrorist incident, threat, or activity. Further, use of the information is limited to use in a Federal investigation, analysis, or proceeding concerning a terrorist incident, threat, or activity. Because the Department of Justice represents the Secretary of the Treasury in Federal district court, the Secretary is permitted to disclose returns and return information to the Department of Justice as necessary and solely for the purpose of obtaining the special IRS ex parte court order.

Disclosure of return information other than by ex parte court order

Disclosure by the IRS without a request

The Code permits the IRS to disclose return information, other than taxpayer return information, related to a terrorist incident, threat, or activity to the extent necessary to apprise the head of the appropriate Federal law enforcement agency responsible for investigating or responding to such terrorist incident, threat, or activity. The IRS on its own initiative and without a written request may make this disclosure. The head of the Federal law enforcement agency may disclose information to officers and employees of such agency to the extent necessary to investigate or respond to such terrorist incident, threat, or activity. A taxpayer's identity is not treated as return information supplied by the taxpayer or his or her representative.

Disclosure upon written request of a Federal law enforcement agency

The Code permits the IRS to disclose return information, other than taxpayer return information, to officers and employees of Federal law enforcement upon a written request satisfying certain requirements. The request must: (1) be made by the head of the Federal law enforcement agency (or his delegate) involved in the response to or investigation of terrorist incidents, threats, or activities, and (2) set forth the specific reason or reasons why such disclosure may be relevant to a terrorist incident, threat, or activity. The information is to be disclosed to officers and employees of the Federal law enforcement agency who would be personally and directly involved in the response to or investigation of terrorist incidents, threats, or activities. The information is to be used by such officers and employees solely for such response or investigation.

The Code permits the redisclosure by a Federal law enforcement agency to officers and employees of State and local law enforcement personally and directly engaged in the response to or investigation of the terrorist incident, threat, or activity. The State or local law enforcement agency must be part of an investigative or response team with the Federal law enforcement agency for these disclosures to be made.

Disclosure upon request from the Departments of Justice or Treasury for intelligence analysis of terrorist activity

Upon written request satisfying certain requirements discussed below, the IRS is to disclose return information (other than taxpayer return information) to officers and employees of the Department of Justice, Department of Treasury, and other Federal intelligence agencies, who are personally and directly engaged in the collection or analysis of intelligence and counterintelligence or investigation concerning terrorist incidents, threats, or activities. Use of the information is limited to use by such officers and employees in such investigation, collection, or analysis.

The written request is to set forth the specific reasons why the information to be disclosed is relevant to a terrorist incident, threat, or activity. The request is to be made by an individual who is: (1) an officer or employee of the Department of Justice or the Department of Treasury, (2) appointed by the President with the advice and consent of the Senate, and (3) responsible for the collection, and analysis of intelligence and counterintelligence information concerning terrorist incidents, threats, or activities. The Director of the United States Secret Service also is an authorized requester under the Act.

Explanation of Provision

The provision extends for one year the present-law terrorist activity disclosure provisions (through December 31, 2007).

Effective date.—The provision applies to disclosures after December 31, 2006.

(c) Disclosure of return information to carry out income contingent repayment of student loans (sec. 6103 of the Code)

Present Law

Present law prohibits the disclosure of returns and return information, except to the extent specifically authorized by the Code. An exception is provided for disclosure to the Department of Education (but not to contractors thereof) of a taxpayer's filing status, adjusted gross income and identity information (i.e., name, mailing address, taxpayer identifying number) to establish an appropriate repayment amount for an applicable student loan. The disclosure authority for the income-contingent loan repayment program is scheduled to expire after December 31, 2006.

The Department of Education utilizes contractors for the income-contingent loan verification program. The specific disclosure exception for the program does not permit disclosure of return information to contractors. As a result, the Department of Education obtains return information from the Internal Revenue Service by taxpayer consent (under section

6103(c)), rather than under the specific exception for the income-contingent loan verification program (sec. 6103(l)(13)).

Explanation of Provision

The provision extends for one year the present law authority to disclose return information for purposes of the income-contingent loan repayment program (through December 31, 2007).

Effective date.—The provision applies to requests made after December 31, 2006.

B. Other Provisions

1. Deduction allowable with respect to income attributable to domestic production activities in Puerto Rico (sec. 199 of the Code)

Present Law

In general

Present law 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 nine percent of such income. 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. For taxpayers subject to the 35-percent corporate income tax rate, the 9-percent deduction effectively reduces the corporate income tax rate to just under 32 percent on qualified production activities income.

Qualified production activities income

In general, "qualified production activities income" is equal to domestic production gross receipts (defined by section 199(c)(4)), reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts; and (2) other expenses, losses, or deductions which are properly allocable to such receipts.

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 property⁷¹ that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States; (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film⁷² produced by the taxpayer; (3) any sale, exchange or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction activities performed in the United States; or (5) engineering or architectural services performed in the United States for construction projects located in the United States.

⁷¹ "Qualifying production property" generally includes any tangible personal property, computer software, or sound recordings.

⁷² "Qualified film" includes any motion picture film or videotape (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 participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

For purposes of section 199, the United States does not include Puerto Rico or other U.S. possessions.⁷³

Wage limitation

For taxable years beginning after May 17, 2006, the amount of the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.⁷⁴ Wages paid to bona fide residents of Puerto Rico generally are not included in the wage limitation amount.⁷⁵

Explanation of Provision

The provision amends section 199 of the Code to include Puerto Rico within the definition of the United States for purposes of determining the domestic production gross receipts of eligible taxpayers. Under the provision, a taxpayer is allowed to treat Puerto Rico as part of the United States for purposes of section 199 (thus allowing the taxpayer to take into account its Puerto Rico business activity for purposes of calculating its domestic production gross receipts and qualified production activities income), but only if all of the taxpayer's gross receipts from sources within Puerto Rico are currently taxable for U.S. Federal income tax purposes. In addition, any such taxpayer is also allowed to take into account wages paid to bona fide residents of Puerto Rico for purposes of calculating the 50-percent wage limitation.

Effective date.—The provision is effective for the first two taxable years beginning after December 31, 2005, and before January 1, 2008.

2. Alternative minimum tax credit relief for individuals; returns required for certain options (secs. 53 and 6039 of the Code)

Present Law

In general

Present law imposes an alternative minimum tax (“AMT”) on an individual taxpayer to the extent the taxpayer's tentative minimum tax liability exceeds his or her regular income tax

⁷³ Sec. 7701(a)(9) (“the term ‘United States’ when used in a geographical sense includes only the States and the District of Columbia”).

⁷⁴ For purposes of the provision, “wages” include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. For taxable years beginning before May 18, 2006, the limitation is based upon all wages paid by the taxpayer, rather than only wages properly allocable to domestic production gross receipts.

⁷⁵ Sec. 3401(a)(8)(C).

liability. An individual's tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed \$175,000 (\$87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is the amount by which the alternative minimum taxable income ("AMTI") exceeds an exemption amount.

An individual's AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

The individual AMT attributable to deferral adjustments generates a minimum tax credit that is allowable to the extent the regular tax (reduced by other nonrefundable credits) exceeds the tentative minimum tax in a future taxable year. Unused minimum tax credits are carried forward indefinitely.

AMT treatment of incentive stock options

One of the adjustments in computing AMTI is the tax treatment of the exercise of an incentive stock option. An incentive stock option is an option granted by a corporation in connection with an individual's employment, so long as the option meets certain specified requirements.⁷⁶ Under the regular tax, the exercise of an incentive stock option is tax-free if the stock is not disposed of within one year of exercise of the option or within two years of the grant of the option.⁷⁷ The individual then computes the long-term capital gain or loss on the sale of the stock using the amount paid for the stock as the cost basis. If the holding period requirements are not satisfied, the individual generally takes into account at the exercise of the option an amount of ordinary income equal to the excess of the fair market value of the stock on the date of exercise over the amount paid for the stock. The cost basis of the stock is increased by the amount taken into account.⁷⁸

Under the individual alternative minimum tax, the exercise of an incentive stock option is treated as the exercise of an option other than an incentive stock option. Under this treatment, generally the individual takes into account as ordinary income for purposes of computing AMTI the excess of the fair market value of the stock at the date of exercise over the amount paid for the stock.⁷⁹ When the stock is later sold, for purposes of computing capital gain or loss for

⁷⁶ Sec. 422.

⁷⁷ Sec. 421.

⁷⁸ If the stock is sold at a loss before the required holding periods are met, the amount taken into account may not exceed the amount realized on the sale over the adjusted basis of the stock. If the stock is sold after the taxable year in which the option was exercised but before the required holding periods are met, the required inclusion is made in the year the stock is sold.

⁷⁹ If the stock is sold in the same taxable year the option is exercised, no adjustment in computing AMTI is required.

purposes of AMTI, the adjusted basis of the stock includes the amount taken into account as AMTI.

The adjustment relating to incentive stock options is a deferral adjustment and therefore generates an AMT credit in the year the stock is sold.⁸⁰

Under present law,⁸¹ employers are required to provide to employees information regarding the transfer of stock pursuant to the exercise of an incentive stock option and to transfers of stock under an employee stock purchase plan where the option price is between 85 percent and 100 percent of the value of the stock.⁸²

Explanation of Provision

Under the provision, an individual's minimum tax credit allowable for any taxable year beginning before January 1, 2013, is not less than the "AMT refundable credit amount". The "AMT refundable credit amount" is the greater of (1) the lesser of \$5,000 or the long-term unused minimum tax credit, or (2) 20 percent of the long-term unused minimum tax credit. The long-term unused minimum tax credit for any taxable year means the portion of the minimum tax credit attributable to the adjusted net minimum tax for taxable years before the 3rd taxable year immediately preceding the taxable year (assuming the credits are used on a first-in, first-out basis). In the case of an individual whose adjusted gross income for a taxable year exceeds the threshold amount (within the meaning of section 151(d)(3)(C)), the AMT refundable credit amount is reduced by the applicable percentage (within the meaning of section 151(d)(3)(B)). The additional credit allowable by reason of this provision is refundable.

The provision requires an employer to make an information return with the IRS, in addition to providing information to the employee, regarding the transfer of stock pursuant to exercise of an incentive stock option, and to certain stock transfers regarding employee stock purchase plans.

Example.—Assume in 2010 an individual has an adjusted gross income that results in an applicable percentage of 50 percent under section 151(d)(3)(B), a regular tax of \$45,000, a tentative minimum tax of \$40,000, no other credits allowable, and a minimum tax credit for the taxable year (before limitation under section 53(c)) of \$1.1 million of which \$1 million is a long-term unused minimum tax credit.

⁸⁰ If the stock is sold for less than the amount paid for the stock, the loss may not be allowed in full in computing AMTI by reason of the \$3,000 limit on the deductibility of net capital losses. Thus, the excess of the regular tax over the tentative minimum tax may not reflect the full amount of the loss.

⁸¹ Sec. 6039.

⁸² Sec. 423(c).

The AMT refundable credit amount for the taxable year is \$100,000 (20 percent of the \$1 million long-term unused minimum tax credit reduced by an applicable percentage of 50 percent). The minimum tax credit allowable for the taxable year is \$100,000 (the greater of the AMT refundable credit amount or the amount of the credit otherwise allowable). The \$5,000 credit allowable without regard to this provision is nonrefundable and the additional \$95,000 of credit allowable by reason of this provision is treated as a refundable credit. Thus, the taxpayer has an overpayment of \$55,000 (\$45,000 regular tax less \$5,000 nonrefundable AMT credit less \$95,000 refundable AMT credit). The \$55,000 overpayment is allowed as a refund or credit to the taxpayer. The remaining \$1 million minimum tax credit is carried forward to future taxable years.

If, in the above example, the adjusted gross income did not exceed the threshold amount under section 151(d)(3)(C), the AMT refundable credit amount for the taxable year would be \$200,000, and the overpayment would be \$155,000.

Effective date.—The provision relating to the minimum tax credit applies to taxable years beginning after the date of enactment.

The provision relating to returns applies to calendar years beginning after the date of enactment.

3. Partial expensing for advanced mine safety equipment (new sec. 179E of the Code)

Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the Modified Accelerated Cost Recovery System (“MACRS”), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property (sec. 168).

Personal property is classified under MACRS based on the property’s class life unless a different classification is specifically provided in section 168. The class life applicable for personal property is the asset guideline period (midpoint class life as of January 1, 1986). Based on the property’s classification, a recovery period is prescribed under MACRS. In general, there are six classes of recovery periods to which personal property can be assigned. For example, personal property that has a class life of four years or less has a recovery period of three years, whereas personal property with a class life greater than four years but less than 10 years has a recovery period of five years. The class lives and recovery periods for most property are contained in Revenue Procedure 87-56.⁸³

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or “expense”) such costs. Present law provides that the maximum amount a

⁸³ 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

taxpayer may expense, for taxable years beginning in 2003 through 2009, is \$100,000 of the cost of qualifying property placed in service for the taxable year. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The \$100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$400,000.

Explanation of Provision

Under the provision, a taxpayer may elect to treat 50 percent of the cost of any qualified advanced mine safety equipment property as a deduction in the taxable year in which the equipment is placed in service.

Advanced mine safety equipment property means any of the following: (1) emergency communication technology or devices used to allow a miner to maintain constant communication with an individual who is not in the mine; (2) electronic identification and location devices that allow individuals not in the mine to track at all times the movements and location of miners working in or at the mine; (3) emergency oxygen-generating, self-rescue devices that provide oxygen for at least 90 minutes; (4) pre-positioned supplies of oxygen providing each miner on a shift the ability to survive for at least 48 hours; and (5) comprehensive atmospheric monitoring systems that monitor the levels of carbon monoxide, methane and oxygen that are present in all areas of the mine and that can detect smoke in the case of a fire in a mine.

To be treated as qualified advanced mine safety equipment property under the provision, the original use of the property must have commenced with the taxpayer, and the taxpayer must have placed the property in service after the date of enactment.

The portion of the cost of any property with respect to which an expensing election under section 179 is made may not be taken into account for purposes of the 50-percent deduction allowed under this provision. For Federal tax purposes, the basis of property is reduced by the portion of its cost that is taken into account for purposes of the 50-percent deduction allowed under the provision.

The provision requires the taxpayer to report information required by the Treasury Secretary with respect to the operation of mines of the taxpayer, in order for the deduction to be allowed for the taxable year.

The provision includes a termination rule providing that it does not apply to property placed in service after December 31, 2008.

Effective date.—The provision applies to costs paid or incurred after the date of enactment, with regard to property placed in service on or before December 31, 2008.

4. Mine rescue team training credit (new sec. 45N of the Code)

Present Law

There is no present law credit for expenditures incurred by a taxpayer to train mine rescue workers. In general, a deduction is allowed for all ordinary and necessary expenses that

are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business.⁸⁴ A taxpayer that employs individuals as miners in underground mines will generally be permitted to deduct as ordinary and necessary expenses the educational expenditures such taxpayer incurs to train its employees in the principles, procedures, and techniques of mine rescue, as well as the wages paid by the taxpayer for the time its employees were engaged in such training.

Explanation of Provision

Under the provision, a taxpayer which is an eligible employer may claim a credit with respect to each qualified mine rescue team employee equal to the lesser of (1) 20 percent of the amount paid or incurred by the taxpayer during the taxable year with respect to the training program costs of such qualified mine rescue team employee (including wages of the employee), or (2) \$10,000.⁸⁵ An eligible employer is any taxpayer which employs individuals as miners in underground mines in the United States. No deduction is allowed for the amount of the expenses otherwise deductible which is equal to the amount of the credit.

A qualified mine rescue team employee is any full-time employee of the taxpayer who is a miner eligible for more than six months of a taxable year to serve as a mine rescue team member by virtue of either having completed the initial 20-hour course of instruction prescribed by the Mine Safety and Health Administration's Office of Educational Policy and Development, or receiving at least 40 hours of refresher training in such instruction.

Effective date.—The provision is effective for taxable years beginning after December 31, 2005, and before January 1, 2009.

5. Whistleblower reforms (sec. 7623 of the Code)

Present Law

The Code authorizes the IRS to pay such sums as deemed necessary for: “(1) detecting underpayments of tax; and (2) detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving at the same.”⁸⁶ Amounts are paid based on a percentage of tax, fines, and penalties (but not interest) actually collected based on the information provided. For specific information that caused the investigation and resulted in recovery, the IRS administratively has set the reward in an amount not to exceed 15 percent of the amounts recovered. For information, although not specific, that nonetheless caused the investigation and was of value in the determination of tax liabilities, the reward is not to exceed 10 percent of the amount recovered. For information that caused the investigation, but had no direct relationship to the determination of tax liabilities, the reward is not to exceed one percent

⁸⁴ Sec. 162(a).

⁸⁵ The credit is part of the general business credit (sec. 38).

⁸⁶ Sec. 7623.

of the amount recovered. The reward ceiling is \$10 million (for payments made after November 7, 2002), and the reward floor is \$100. No reward will be paid if the recovery was so small as to call for payment of less than \$100 under the above formulas. Both the ceiling and percentages can be increased with a special agreement. The Code permits the IRS to disclose return information pursuant to a contract for tax administration services.⁸⁷

Explanation of Provision

The provision reforms the reward program for individuals who provide information regarding violations of the tax laws to the Secretary. Generally, the provision establishes a reward floor of 15 percent of the collected proceeds (including penalties, interest, additions to tax and additional amounts) if the IRS moves forward with an administrative or judicial action based on information brought to the IRS's attention by an individual. The provision caps the available reward at 30 percent of the collected proceeds. The provision permits awards of lesser amounts (but no less than 10 percent) if the action was based principally on allegations (other than information provided by the individual) resulting from a judicial or administrative hearing, government report, hearing, audit, investigation, or from the news media.

The provision requires the Secretary to issue guidance within one year of the date of enactment for the operation of a Whistleblower Office within the IRS to administer the reward program. To the extent possible, it is expected that such guidance will address the recommendations of the Treasury Inspector General for Tax Administration regarding the informant's reward program, including the recommendations to centralize management of the reward program and to reduce the processing time for claims.⁸⁸ Under the provision, the Whistleblower Office may seek assistance from the individual providing information or from his or her legal representative, and may reimburse the costs incurred by any legal representative out of the amount of the reward. To the extent the disclosure of returns or return information is required to render such assistance, the disclosure must be pursuant to an IRS tax administration contract. It is expected that such disclosures will be infrequent and will be made only when the assigned task cannot be properly or timely completed without the return information to be disclosed.

The provision also provides an above-the-line deduction for attorneys' fees and costs paid by, or on behalf of, the individual in connection with any award for providing information regarding violations of the tax laws. The amount that may be deducted above-the-line may not exceed the amount includible in the taxpayer's gross income for the taxable year on account of such award (whether by suit or agreement and whether as lump sum or periodic payments).

The provision permits an individual to appeal the amount or a denial of an award determination to the United States Tax Court (the "Tax Court") within 30 days of such

⁸⁷ Sec. 6103(n).

⁸⁸ Treasury Inspector General for Tax Administration, *The Informants' Rewards Program Needs More Centralized Management Oversight*, 2006-30-092 (June 2006).

determination. Under the provision, Tax Court review of an award determination may be assigned to a special trial judge.

In addition, the provision requires the Secretary to conduct a study and report to Congress on the effectiveness of the whistleblower reward program and any legislative or administrative recommendations regarding the administration of the program.

Effective date.—The provision generally is effective for information provided on or after the date of enactment.

6. Frivolous tax submissions (sec. 6702 of the Code)

Present Law

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of \$500 imposed by the IRS (sec. 6702). The Code also permits the Tax Court⁸⁹ to impose a penalty of up to \$25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

Explanation of Provision

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

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

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

Effective date.—The provision applies to submissions made and issues raised after the date on which the Secretary first prescribes the required list of frivolous positions.

⁸⁹ Because in general the Tax Court is the only pre-payment forum available to taxpayers, it deals with most of the frivolous, groundless, or dilatory arguments raised in tax cases.

7. Addition of meningococcal and human papillomavirus vaccines to the list of taxable vaccines (sec. 4132 of the Code)

Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose⁹⁰ on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis A, hepatitis B, varicella (chicken pox), rotavirus gastroenteritis, streptococcus pneumoniae and trivalent vaccines against influenza. The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a Federal "no fault" insurance system substitute for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

Explanation of Provision

The provision adds meningococcal vaccines and human papillomavirus vaccines to the list of taxable vaccines.

Effective date.—The provision is effective for vaccines sold or used on or after the first day of the first month beginning more than four weeks after the date of enactment.

In the case of sales on or before the effective date for which delivery is made after such date, the delivery date shall be considered the sale date.

8. Make permanent the tax treatment of certain settlement funds

Present Law

The cleanup of hazardous waste sites is sometimes funded by environmental "settlement funds" or escrow accounts. These escrow accounts are established in consent decrees between the Environmental Protection Agency ("EPA") and the settling parties under the jurisdiction of a Federal district court. The EPA uses these accounts to resolve claims against private parties under Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA").

⁹⁰ Sec. 4131.

Present law provides that certain settlement funds established in consent decrees for the sole purpose of resolving claims under CERCLA are to be treated as beneficially owned by the United States government and therefore, not subject to Federal income tax.

To qualify the settlement fund must be: (1) established pursuant to a consent decree entered by a judge of a United States District Court; (2) created for the receipt of settlement payments for the sole purpose of resolving claims under CERCLA; (3) controlled (in terms of expenditures of contributions and earnings thereon) by the government or an agency or instrumentality thereof; and (4) upon termination, any remaining funds will be disbursed to such government entity and used in accordance with applicable law. For purposes of the provision, a government entity means the United States, any State of political subdivision thereof, the District of Columbia, any possession of the United States, and any agency or instrumentality of the foregoing.

The provision does not apply to accounts or funds established after December 31, 2010.

Explanation of Provision

The provision permanently extends to funds and accounts established after December 31, 2010, the treatment of certain settlement funds as beneficially owned by the United States government and therefore, not subject to Federal income tax.

Effective date.—The provision is effective as if included in section 201 of the Tax Increase Prevention and Reconciliation Act of 2005.

9. Make permanent the active business rules relating to taxation of distributions of stock and securities of a controlled corporation (sec. 355 of the Code)

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if the corporation had sold such property for its fair market value. In addition, the shareholders receiving the distributed property are ordinarily treated as receiving a dividend of the value of the distribution (to the extent of the distributing corporation's earnings and profits), or capital gain in the case of a stock buyback that significantly reduces the shareholder's interest in the parent corporation.

An exception to these rules applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355 of the Code. If all the requirements are satisfied, there is no tax to the distributing corporation or to the shareholders on the distribution.

One requirement to qualify for tax-free treatment under section 355 is that both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period (the "active business

test”).⁹¹ For this purpose, prior to the enactment of the Tax Increase Prevention and Reconciliation Act of 2005, if the distributing or the controlled corporation to which the test was being applied was itself the parent of other subsidiary corporations, the determination whether such parent corporation was considered engaged in the active conduct of a trade or business was made only at that parent corporation level. The test would be satisfied only if (1) that corporation itself was directly engaged in the active conduct of a trade or business, or (2) that corporation was not directly engaged in the active conduct of a trade or business, but substantially all its assets consisted of stock and securities of one or more corporations that it controls that are engaged in the active conduct of a trade or business.⁹² Thus, different tests applied, depending upon whether the corporation being tested itself was engaged in the active conduct of a trade or business, or whether it was a holding company holding stock of other corporations that were engaged in the active conduct of a trade or business.

The Tax Increase Prevention and Reconciliation Act of 2005 provided that the active trade or business test is always determined by reference to the relevant affiliated group. For the distributing corporation, the relevant affiliated group consists of the distributing corporation as the common parent and all corporations affiliated with the distributing corporation through stock ownership described in section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under section 1504(b)), immediately after the distribution. The relevant affiliated group for a controlled corporation is determined in a similar manner (with the controlled corporation as the common parent).

The provision enacted in the Tax Increase Prevention and Reconciliation Act of 2005 applies to distributions after the date of enactment and on or before December 31, 2010, with three exceptions. The provision does not apply to distributions (1) made pursuant to an agreement which is binding on the date of enactment and at all times thereafter, (2) described in a ruling request submitted to the IRS on or before the date of enactment, or (3) described on or before the date of enactment in a public announcement or in a filing with the Securities and Exchange Commission. The distributing corporation may irrevocably elect not to have the exceptions described above apply.

The provision also applies, solely for the purpose of determining whether, after the date of enactment, there is continuing qualification under the requirements of section 355(b)(2)(A) of

⁹¹ Section 355(b). In determining whether a corporation is engaged in an active trade or business that satisfies the requirement, old IRS guidelines for advance ruling purposes required that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least five percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business. Rev. Proc. 2003-3, sec. 4.01(30), 2003-1 I.R.B. 113. More recently, the IRS suspended this specific rule in connection with its general administrative practice of moving IRS resources away from advance rulings on factual aspects of section 355 transactions in general. Rev. Proc. 2003-48, 2003-29 I.R.B. 86.

⁹² Section 355(b)(2)(A). The IRS position has been that the statutory “substantially all” test has required that at least 90 percent of the fair market value of the corporation’s gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business. Rev. Proc. 96-30, sec. 4.03(5), 1996-1 C.B. 696; Rev. Proc. 77-37, sec. 3.04, 1977-2 C.B. 568.

distributions made before such date, as a result of an acquisition, disposition, or other restructuring after such date on or before December 31, 2010.⁹³

Explanation of Provision

The provision deletes the sunset date of December 31, 2010, for all purposes of the provision enacted in the Tax Increase Prevention and Reconciliation Act of 2005. Thus, the provision is made permanent.

Effective date.—The provision is effective as if included in section 202 of the Tax Increase Prevention and Reconciliation Act of 2005.

10. Make permanent the modifications to qualified veterans' mortgage bonds (sec. 143 of the Code)

Present Law

Private activity bonds are bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such private person. The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes (“qualified private activity bonds”). The definition of a qualified private activity bond includes both qualified mortgage bonds and qualified veterans' mortgage bonds.

Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers and purchase price limitations for the home financed with bond proceeds. In addition, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the “first-time homebuyer” requirement).

Qualified veterans' mortgage bonds are private activity bonds the proceeds of which are used to make mortgage loans to certain veterans. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984. Qualified veterans' mortgage bonds are not subject to the State volume limitations generally applicable to private activity bonds. Instead, annual issuance in each State is subject to a separate State volume limitation. The five States eligible to issue these bonds are Alaska, California, Oregon, Texas,

⁹³ For example, a holding company taxpayer that had distributed a controlled corporation in a spin-off prior to the date of enactment, in which spin-off the taxpayer satisfied the “substantially all” active business stock test of prior law section 355(b)(2)(A) immediately after the distribution, would not be deemed to have failed to satisfy any requirement that it continue that same qualified structure for any period of time after the distribution, solely because of a restructuring that occurred after the date of enactment and before January 1, 2010, and that would satisfy the requirements of new section 355(b)(2)(A).

and Wisconsin. Loans financed with qualified veterans' mortgage bonds can be made only with respect to principal residences and can not be made to acquire or replace existing mortgages. Under prior law, mortgage loans made with the proceeds of bonds issued by the five States could be made only to veterans who served on active duty before 1977 and who applied for the financing before the date 30 years after the last date on which such veteran left active service (the "eligibility period"). However, in the case of qualified veterans' mortgage bonds issued by the States of Alaska, Oregon, and Wisconsin, the Tax Increase Prevention and Reconciliation Act of 2005 repealed the requirement that veterans receiving loans financed with qualified veterans' mortgage bonds must have served before 1977 and reduced the eligibility period to 25 years (rather than 30 years) following release from the military service.

In addition, the Act provided new State volume limits for qualified veterans' mortgage bonds issued in the States of Alaska, Oregon and Wisconsin. In 2010, the new annual limit on the total volume of veterans' bonds that can be issued in each of these three States is \$25 million. These volume limits are phased-in over the four-year period immediately preceding 2010 by allowing the applicable percentage of the 2010 volume limits. The following table provides those percentages.

Calendar Year:	Applicable Percentage is:
2006	20 percent
2007	40 percent
2008	60 percent
2009	80 percent

The volume limits are zero for 2011 and each year thereafter. Unused allocation cannot be carried forward to subsequent years.

Explanation of Provision

The provision makes permanent the Act's changes to the definition of an eligible veteran and the State volume limits for qualified veterans' mortgage bonds issued by the States of Alaska, Oregon, and Wisconsin. The total volume of veterans' bonds that can be issued in each of these three States is \$25 million for 2010 and each calendar year thereafter.

Effective date.—The provision is effective as if included in section 203 of the Tax Increase Prevention and Reconciliation Act of 2005.

11. Capital gains treatment for certain self-created musical works (sec. 1221 of the Code)

Present Law

Capital gains

The maximum tax rate on the net capital gain income of an individual is 15 percent for taxable years beginning in 2006. By contrast, the maximum tax rate on an individual's ordinary

income is 35 percent. The reduced 15-percent rate generally is available for gain from the sale or exchange of a capital asset for which the taxpayer has satisfied a holding-period requirement. Capital assets generally include all property held by a taxpayer with certain specified exclusions.

An exclusion from the definition of a capital asset applies to inventory property or property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.⁹⁴ Another exclusion from capital asset status applies to copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property held by a taxpayer whose personal efforts created the property (or held by a taxpayer whose basis in the property is determined by reference to the basis of the taxpayer whose personal efforts created the property).⁹⁵ Under a provision included in the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"),⁹⁶ at the election of a taxpayer, the section 1221(a)(1) and (a)(3) exclusions from capital asset status do not apply to musical compositions or copyrights in musical works sold or exchanged before January 1, 2011 by a taxpayer described in section 1221(a)(3).⁹⁷ Thus, if a taxpayer who owns musical compositions or copyrights in musical works that the taxpayer created (or if a taxpayer to which the musical compositions or copyrights have been transferred by the works' creator in a substituted basis transaction) elects the application of this provision, gain from a sale of the compositions or copyrights is treated as capital gain, not ordinary income.

Charitable contributions

A taxpayer generally is allowed a deduction for the fair market value of property contributed to a charity. If a taxpayer makes a contribution of property that would have generated ordinary income (or short-term capital gain), the taxpayer's charitable contribution deduction generally is limited to the property's adjusted basis.⁹⁸ The determination whether property would have generated ordinary income (or short-term capital gain) is made without regard to new section 1221(b)(3) described above.⁹⁹

Explanation of Provision

The provision makes permanent the availability of the section 1221(b)(3) election to treat certain sales of musical compositions or copyrights in musical works as being sales of capital assets (and therefore as generating capital gain). The provision also makes permanent the

⁹⁴ Sec. 1221(a)(1).

⁹⁵ Sec. 1221(a)(3).

⁹⁶ Pub. L. No. 109-222, sec. 204(a) (2006).

⁹⁷ Sec. 1221(b)(3).

⁹⁸ Sec. 170(e)(1)(A).

⁹⁹ Sec. 170(e)(1)(A), as modified by TIPRA, Pub. L. No. 109-222, sec. 204(b) (2006).

accompanying rule limiting to adjusted basis the amount of a charitable contribution deduction allowed for musical compositions or copyrights in musical works to which a taxpayer has elected the application of section 1221(b)(3).

Effective date.—The provision is effective as if included in section 204 of the Tax Increase Prevention and Reconciliation Act of 2005.

12. Make permanent the decrease in minimum vessel tonnage limit to 6,000 deadweight tons (sec. 1355 of the Code)

Present Law

The United States employs a “worldwide” tax system, under which domestic corporations generally are taxed on all income, including income from shipping operations, whether derived in the United States or abroad. In order to mitigate double taxation, a foreign tax credit for income taxes paid to foreign countries is provided to reduce or eliminate the U.S. tax owed on such income, subject to certain limitations.

Generally, the United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income, including income from shipping operations, which is “effectively connected” with the conduct of a trade or business in the United States (sec. 882). Such “effectively connected income” generally is taxed in the same manner and at the same rates as the income of a U.S. corporation.

The United States imposes a four percent tax on the amount of a foreign corporation’s U.S. source gross transportation income (sec. 887). Transportation income includes income from the use (or hiring or leasing for use) of a vessel and income from services directly related to the use of a vessel. Fifty percent of the transportation income attributable to transportation that either begins or ends (but not both) in the United States is treated as U.S. source gross transportation income. The tax does not apply, however, to U.S. source gross transportation income that is treated as income effectively connected with the conduct of a U.S. trade or business. U.S. source gross transportation income is not treated as effectively connected income unless (1) the taxpayer has a fixed place of business in the United States involved in earning the income, and (2) substantially all the income is attributable to regularly scheduled transportation.

The tax imposed by section 882 or 887 on income from shipping operations may be limited by an applicable U.S. income tax treaty or by an exemption of a foreign corporation’s international shipping operations income in instances where a foreign country grants an equivalent exemption (sec. 883).

Notwithstanding the general rules described above, the American Jobs Creation Act of 2004 (“AJCA”)¹⁰⁰ generally allows corporations that are qualifying vessel operators¹⁰¹ to elect a

¹⁰⁰ Pub. L. No. 108-357, sec. 248. The tonnage tax regime is effective for taxable years beginning after the date of enactment of AJCA (October 22, 2004).

“tonnage tax” in lieu of the corporate income tax on taxable income from certain shipping activities. Accordingly, an electing corporation’s gross income does not include its income from qualifying shipping activities (and items of loss, deduction, or credit are disallowed with respect to such excluded income), and electing corporations are only subject to tax on these activities at the maximum corporate income tax rate on their notional shipping income, which is based on the net tonnage of the corporation’s qualifying vessels.¹⁰² No deductions are allowed against the notional shipping income of an electing corporation, and no credit is allowed against the notional tax imposed under the tonnage tax regime. In addition, special deferral rules apply to the gain on the sale of a qualifying vessel, if such vessel is replaced during a limited replacement period.

Prior to the enactment of the Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”),¹⁰³ a “qualifying vessel” was defined as a self-propelled (or a combination of self-propelled and non-self-propelled) United States flag vessel of not less than 10,000 deadweight tons¹⁰⁴ that is used exclusively in the United States foreign trade. TIPRA expands the definition of “qualifying vessel” to include self-propelled (or a combination of self-propelled and non-self-propelled) United States flag vessels of not less than 6,000 deadweight tons used exclusively in the United States foreign trade. The modified definition of TIPRA applies for taxable years beginning after December 31, 2005 and ending before January 1, 2011.

Explanation of Provision

The provision makes permanent the minimum 6,000 deadweight tons threshold.

Effective date.—The provision is effective as if included in section 205 of the Tax Increase Prevention and Reconciliation Act of 2005.

¹⁰¹ Generally, a qualifying vessel operator is a corporation that (1) operates one or more qualifying vessels and (2) meets certain requirements with respect to its shipping activities.

¹⁰² An electing corporation’s notional shipping income for the taxable year is the product of the following amounts for each of the qualifying vessels it operates: (1) the daily notional shipping income from the operation of the qualifying vessel, and (2) the number of days during the taxable year that the electing corporation operated such vessel as a qualifying vessel in the United States foreign trade. The daily notional shipping income from the operation of a qualifying vessel is (1) 40 cents for each 100 tons of so much of the net tonnage of the vessel as does not exceed 25,000 net tons, and (2) 20 cents for each 100 tons of so much of the net tonnage of the vessel as exceeds 25,000 net tons. “United States foreign trade” means the transportation of goods or passengers between a place in the United States and a foreign place or between foreign places. The temporary use in the United States domestic trade (i.e., the transportation of goods or passengers between places in the United States) of any qualifying vessel or the temporary ceasing to use a qualifying vessel may be disregarded, under special rules.

¹⁰³ Pub. L. No. 109-222, sec. 205 (May 17, 2006).

¹⁰⁴ Deadweight measures the lifting capacity of a ship expressed in long tons (2,240 lbs.), including cargo, crew, and consumables such as fuel, lube oil, drinking water, and stores. It is the difference between the number of tons of water a vessel displaces without such items on board and the number of tons it displaces when fully loaded.

13. Make permanent the modification of special arbitrage rule for certain funds

Present Law

In general, present-law tax-exempt bond arbitrage restrictions provide that interest on a State or local government bond is not eligible for tax-exemption if the proceeds are invested, directly or indirectly, in materially higher yielding investments or if the debt service on the bond is secured by or paid from (directly or indirectly) such investments. An exception to the arbitrage restrictions, enacted in 1984, provides that the pledge of income from investments in the Texas Permanent University Fund (the “Fund”) as security for a limited amount of tax-exempt bonds will not cause interest on those bonds to be taxable. The terms of this exception are limited to State constitutional or statutory restrictions continuously in effect since October 9, 1969. In addition, the exception only applies to an amount of tax-exempt bonds that does not exceed 20 percent of the value of the Fund.

The Fund consists of certain State lands that were set aside for the benefit of higher education, the income from mineral rights to these lands, and certain other earnings on Fund assets. The Texas constitution directs that monies held in the Fund are to be invested in interest-bearing obligations and other securities. Income from the Fund is apportioned between two university systems operated by the State. Tax-exempt bonds issued by the university systems to finance buildings and other permanent improvements were secured by and payable from the income of the Fund.

Prior to 1999, the constitution did not permit the expenditure or mortgage of the Fund for any purpose. In 1999, the State constitutional rules governing the Fund were modified with regard to the manner in which amounts in the Fund are distributed for the benefit of the two university systems. The State constitutional amendments allow for the possibility that in the event investment earnings are less than annual debt service on the bonds some of the debt service could be considered as having been paid with the Fund corpus. The 1984 exception refers only to bonds secured by investment earnings on securities or obligations held by the Fund. Despite the constitutional amendments, the IRS has agreed to continue to apply the 1984 exception to the Fund through August 31, 2007, if clarifying legislation is introduced in the 109th Congress prior to August 31, 2005. Clarifying legislation was introduced in the 109th Congress on May 26, 2005.¹⁰⁵

The Tax Increase Prevention and Reconciliation Act of 2005 codified and extended the IRS agreement until August 31, 2009. The Act conformed the 1984 exception to the State constitutional amendments to permit its continued applicability to bonds of the two university systems. The limitation on the aggregate amount of bonds which may benefit from the exception was not modified, and remains at 20 percent of the value of the Fund.

Explanation of Provision

The provision makes permanent the Act’s changes to the Fund’s arbitrage exception.

¹⁰⁵ H.R. 2661.

Effective date.—The provision is effective as if included in section 206 of the Tax Increase Prevention and Reconciliation Act of 2005.

14. Great Lakes domestic shipping to not disqualify vessel from tonnage tax (sec. 1355 of the Code)

Present Law

The United States employs a “worldwide” tax system, under which domestic corporations generally are taxed on all income, including income from shipping operations, whether derived in the United States or abroad. In order to mitigate double taxation, a foreign tax credit for income taxes paid to foreign countries is provided to reduce or eliminate the U.S. tax owed on such income, subject to certain limitations.

Generally, the United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income, including income from shipping operations, which is “effectively connected” with the conduct of a trade or business in the United States (sec. 882). Such “effectively connected income” generally is taxed in the same manner and at the same rates as the income of a U.S. corporation.

The United States imposes a four percent tax on the amount of a foreign corporation’s U.S. source gross transportation income (sec. 887). Transportation income includes income from the use (or hiring or leasing for use) of a vessel and income from services directly related to the use of a vessel. Fifty percent of the transportation income attributable to transportation that either begins or ends (but not both) in the United States is treated as U.S. source gross transportation income. The tax does not apply, however, to U.S. source gross transportation income that is treated as income effectively connected with the conduct of a U.S. trade or business. U.S. source gross transportation income is not treated as effectively connected income unless (1) the taxpayer has a fixed place of business in the United States involved in earning the income, and (2) substantially all the income is attributable to regularly scheduled transportation.

The tax imposed by section 882 or 887 on income from shipping operations may be limited by an applicable U.S. income tax treaty or by an exemption of a foreign corporation’s international shipping operations income in instances where a foreign country grants an equivalent exemption (sec. 883).

Notwithstanding the general rules described above, the American Jobs Creation Act of 2004 (“AJCA”)¹⁰⁶ generally allows corporations that are qualifying vessel operators¹⁰⁷ to elect a “tonnage tax” in lieu of the corporate income tax on taxable income from certain shipping

¹⁰⁶ Pub. L. No. 108-357, sec. 248. The tonnage tax regime is effective for taxable years beginning after the date of enactment of AJCA (October 22, 2004).

¹⁰⁷ Generally, a qualifying vessel operator is a corporation that (1) operates one or more qualifying vessels and (2) meets certain requirements with respect to its shipping activities.

activities. Accordingly, an electing corporation's gross income does not include its income from qualifying shipping activities (and items of loss, deduction, and credit are disallowed with respect to such excluded income),¹⁰⁸ and electing corporations are only subject to tax on these activities at the maximum corporate income tax rate on their notional shipping income, which is based on the net tonnage of the corporation's qualifying vessels operated in the United States foreign trade.¹⁰⁹ "United States foreign trade" means the transportation of goods or passengers between a place in the United States and a foreign place or between foreign places. No deductions are allowed against the notional shipping income of an electing corporation, and no credit is allowed against the notional tax imposed under the tonnage tax regime. In addition, special deferral rules apply to the gain on the sale of a qualifying vessel, if such vessel is replaced during a limited replacement period.

A "qualifying vessel" is defined as a self-propelled (or a combination of self-propelled and non-self-propelled) United States flag vessel of not less than 6,000 deadweight tons¹¹⁰ that is used exclusively in the United States foreign trade. Notwithstanding the "exclusively in the United States foreign trade" requirement, the temporary use of any qualifying vessel in the United States domestic trade (i.e., the transportation of goods or passengers between places in the United States) may be disregarded, and treated as the continued use of such vessel in the United States foreign trade, if the electing corporation provides timely notice of such temporary use to the Secretary. However, if a qualifying vessel is operated in the United States domestic trade for more than 30 days during the taxable year, then no usage in the United States domestic trade during such year may be disregarded (and the vessel is thereby disqualified). The Secretary has the authority to prescribe regulations as may be necessary or appropriate to carry out the purposes of the statutory rules relating to the temporary domestic use of vessels.¹¹¹

¹⁰⁸ Sec. 1357.

¹⁰⁹ An electing corporation's notional shipping income for the taxable year is the product of the following amounts for each of the qualifying vessels it operates: (1) the daily notional shipping income from the operation of the qualifying vessel, and (2) the number of days during the taxable year that the electing corporation operated such vessel as a qualifying vessel in the United States foreign trade. The daily notional shipping income from the operation of a qualifying vessel is (1) 40 cents for each 100 tons of so much of the net tonnage of the vessel as does not exceed 25,000 net tons, and (2) 20 cents for each 100 tons of so much of the net tonnage of the vessel as exceeds 25,000 net tons.

¹¹⁰ Prior to the enactment on May 17, 2006 of Pub. L. No. 109-222, the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), "qualifying vessel" meant a self-propelled (or a combination of self-propelled and non-self-propelled) United States flag vessel of not less than 10,000 deadweight tons used exclusively in the United States foreign trade. TIPRA changed the threshold to 6,000 deadweight tons, effective for taxable years beginning after December 31, 2005 and ending before January 1, 2011. Section 1283 of this Act permanently extends the 6,000 deadweight tons threshold.

¹¹¹ Sec. 1355(g).

Explanation of Provision

Under the provision, a corporation for which a tonnage tax election is in effect (“electing corporation”) may make a further election with respect to a qualifying vessel used during a taxable year in “qualified zone domestic trade.” The term “qualified zone domestic trade” means the transportation of goods or passengers between places in the “qualified zone” if such transportation is in the United States domestic trade. The transportation of goods or passengers between a U.S. port in the qualified zone and a U.S. port outside the qualified zone (in either direction) is United States domestic trade that is not qualified zone domestic trade.

The term “qualified zone” means the Great Lakes Waterway and the St. Lawrence Seaway. This area consists of the deep-draft waterways of Lake Superior, Lake Michigan, Lake Huron (including Lake St. Clair), Lake Erie, and Lake Ontario, connecting deep-draft channels, including the Detroit River, the St. Clair River, the St. Marys River, and the Welland Canal, and the waterway between the port of Sept-Îles, Quebec and Lake Ontario, including all locks, canals, and connecting and contiguous waters that are part of these deep-draft waterways.

Activities in qualified zone domestic trade are not qualifying shipping activities and, therefore, do not qualify for the tonnage tax regime. In the case of a qualifying vessel for which an election under this provision (“qualified zone domestic trade election”) is in force, the Secretary is to prescribe rules for the proper allocation of income, expenses, losses, and deductions between the qualified shipping activities and the other activities of such vessel. These rules may include intra-vessel allocation rules that are different than the rules pertaining to allocations of items between qualifying vessels and other vessels.

An electing corporation making a qualified zone domestic trade election with respect to a vessel is not required to give notice to the Secretary of the use of such vessel in qualified zone domestic trade, and an otherwise qualifying vessel does not cease to be a qualifying vessel solely due to such use when such election is in effect, even if such use exceeds 30 days during the taxable year. An electing corporation making a qualified zone domestic trade election with respect to a vessel is treated as using such vessel in qualified zone domestic trade during any period of temporary use in the United States domestic trade (other than qualified zone domestic trade) if such electing corporation gives timely notice to the Secretary stating that it temporarily operates or has operated in the United States domestic trade (other than qualified zone domestic trade) a qualifying vessel which had been used in the United States foreign trade or qualified zone domestic trade, and that it intends to resume operating such vessel in the United States foreign trade or qualified zone domestic trade. The period of such permissible temporary use of such vessel in such United States domestic trade continues until the earlier of the date on which the electing corporation abandons its intention to resume operation of the vessel in the United States foreign trade or qualified zone domestic trade, or the electing corporation resumes operation of the vessel in the United States foreign trade or qualified zone domestic trade. However, if a qualifying vessel is operated in the United States domestic trade (other than qualified zone domestic trade) for more than 30 days during the taxable year, then no usage in the United States domestic trade (other than qualified zone domestic trade) during such year may be disregarded (and the vessel is thereby disqualified). Thus, a vessel used for 120 days in the taxable year in qualified zone domestic trade and 180 days in the taxable year in the United

States foreign trade is not a qualifying vessel if it is used for over 30 days in the taxable year in the United States domestic trade that is not qualified zone domestic trade.

Under the provision, the Secretary may specify the time, manner and other conditions for making, maintaining, and terminating the qualified zone domestic trade election.

Effective date.—The provision is effective for taxable years beginning after date of enactment.

15. Expansion of the qualified mortgage bond program (sec. 143 of the Code)

Present Law

Private activity bonds are bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such private person. The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes (“qualified private activity bonds”). The definition of a qualified private activity bond includes both qualified mortgage bonds and qualified veterans’ mortgage bonds.

Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers and purchase price limitations for the home financed with bond proceeds. In addition, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the “first-time homebuyer” requirement).

Qualified veterans’ mortgage bonds are private activity bonds the proceeds of which are used to make mortgage loans to certain veterans. Authority to issue qualified veterans’ mortgage bonds is limited to States that had issued such bonds before June 22, 1984. Qualified veterans’ mortgage bonds are not subject to the State volume limitations generally applicable to private activity bonds. Instead, annual issuance in each State is subject to a separate State volume limitation. The five States eligible to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin. Loans financed with qualified veterans’ mortgage bonds can be made only with respect to principal residences and can not be made to acquire or replace existing mortgages. Under prior law, mortgage loans made with the proceeds of bonds issued by the five States could be made only to veterans who served on active duty before 1977 and who applied for the financing before the date 30 years after the last date on which such veteran left active service (the “eligibility period”). However, in the case of qualified veterans’ mortgage bonds issued by the States of Alaska, Oregon, and Wisconsin, the Tax Increase Prevention and Reconciliation Act of 2005 repealed the requirement that veterans receiving loans financed with qualified veterans’ mortgage bonds must have served before 1977 and reduced the eligibility period to 25 years (rather than 30 years) following release from the military service. In addition, the Act provided new State volume limits for qualified veterans’ mortgage bonds issued in the States of Alaska, Oregon and Wisconsin, phased-in over a four-year period.

Explanation of Provision

Under the provision, qualified mortgage bonds may be issued to finance mortgages for veterans who served in the active military without regard to the first-time homebuyer requirement. Present-law income and purchase price limitations apply to loans to veterans financed with the proceeds of qualified mortgage bonds. Veterans are eligible for the exception from the first-time homebuyer requirement without regard to the date they last served on active duty or the date they applied for a loan after leaving active duty. However, veterans may only use the exception one time.

Effective date.—The provision applies to bonds issued after the date of enactment and before January 1, 2008.

16. Exclusion of gain on sale of a principal residence by a member of the intelligence community (sec. 121 of the Code)

Present Law

Under present law, an individual taxpayer may exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the \$250,000 (\$500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met.

Present law also contains special rules relating to members of the uniformed services or the Foreign Service of the United States. An individual may elect to suspend for a maximum of 10 years the five-year test period for ownership and use during certain absences due to service in the uniformed services or the Foreign Service of the United States. The uniformed services include: (1) the Armed Forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to 10 years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty as a member of the uniformed services or in the Foreign Service of the United States. For these purposes, qualified official extended duty is any period of extended duty while serving at a place of duty at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in Government furnished quarters. Extended duty is defined as any period of duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. The election may be made with respect to only one property for a suspension period.

Explanation of Provision

Under the provision, specified employees of the intelligence community may elect to suspend the running of the five-year test period during any period in which they are serving on

extended duty. The term “employee of the intelligence community” means an employee of the Office of the Director of National Intelligence, the Central Intelligence Agency, the National Security Agency, the Defense Intelligence Agency, the National Geospatial-Intelligence Agency, or the National Reconnaissance Office. The term also includes employment with: (1) any other office within the Department of Defense for the collection of specialized national intelligence through reconnaissance programs; (2) any of the intelligence elements of the Army, the Navy, the Air Force, the Marine Corps, the Federal Bureau of Investigation, the Department of the Treasury, the Department of Energy, and the Coast Guard; (3) the Bureau of Intelligence and Research of the Department of State; and (4) the elements of the Department of Homeland Security concerned with the analyses of foreign intelligence information. To qualify, a specified employee must move from one duty station to another and the new duty station must be located outside of the United States. As under present law, the five-year period may not be extended more than 10 years.

Effective date.—The provision is effective for sales and exchanges after the date of enactment and before January 1, 2011.

17. Modification of credit for fuel from a non-conventional source (sec. 45K of the Code)

Present Law

Certain fuels produced from “non-conventional sources” and sold to unrelated parties are eligible for an income tax credit equal to \$3 (generally adjusted for inflation)¹¹² per barrel or Btu oil barrel equivalent (“non-conventional source fuel credit”).¹¹³ Qualified fuels must be produced within the United States.

Qualified fuels include:

- oil produced from shale and tar sands;
- gas produced from geopressured brine, Devonian shale, coal seams, tight formations, or biomass; and
- liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

Generally, the non-conventional source fuel credit has expired, except for certain biomass gas and synthetic fuels sold before January 1, 2008, and produced at facilities placed in service after December 31, 1992, and before July 1, 1998.

¹¹² The inflation adjustment is generally calculated using 1979 as the base year. Generally, the value of the credit for fuel produced in 2005 was \$6.79 per barrel-of-oil equivalent produced, which is approximately \$1.20 per thousand cubic feet of natural gas. In the case of fuel sold after 2005, the credit for coke or coke gas is indexed for inflation using 2004 as the base year instead of 1979.

¹¹³ Sec. 29 (for tax years ending before 2006); sec. 45K (for tax years ending after 2005).

The non-conventional source fuel credit provision also includes a credit for coke or coke gas produced at qualified facilities during a four-year period beginning on the later of January 1, 2006, or the date the facility was placed in service. For purposes of the coke production credit, qualified facilities are facilities placed in service before January 1, 1993, or after June 30, 1998, and before January 1, 2010. The amount of credit-eligible coke produced at any one facility may not exceed an average barrel-of-oil equivalent of 4,000 barrels per day.

The non-conventional source fuel credit is reduced (but not below zero) over a \$6 (inflation-adjusted) phase-out period as the reference price for oil exceeds \$23.50 per barrel (also adjusted for inflation). The reference price is the Secretary's estimate of the annual average wellhead price per barrel for all domestic crude oil. The credit did not phase-out for 2005 because the reference price for that year of \$50.26 did not exceed the inflation adjusted threshold of \$51.35. Beginning with taxable years ending after December 31, 2005, the non-conventional source fuel credit is part of the general business credit (sec. 38).

Explanation of Provision

The provision repeals the phase-out limitation for coke and coke gas otherwise eligible for a credit under section 45K(g). The provision also clarifies that qualifying facilities producing coke and coke gas under section 45K(g) do not include facilities that produce petroleum-based coke or coke gas. The provision does not modify the existing 4,000 barrel-of-oil equivalent per day limitation.

Effective date.—The provision is effective as if included in section 1321 of the Energy Policy Act of 2005.

18. Sale of property to comply with conflict-of interest requirements (sec. 1043 of the Code)

Present Law

Present law provides special rules for deferring the recognition of gain on sales of property which are required in order to comply with certain conflict of interest requirements imposed by the Federal Government. Certain executive branch Federal employees (and their spouses and minor or dependent children) who are required to divest property in order to comply with conflict of interest requirements may elect to postpone the recognition of resulting gains by investing in certain replacement property within a 60-day period. The basis of the replacement property is reduced by the amount of the gain not recognized. Permitted replacement property is limited to any obligation of the United States or any diversified investment fund approved by regulations issued by the Office of Government Ethics. The rule applies only to sales under certificates of divestiture issued by the President or the Director of the Office of Government Ethics.

Explanation of Provision

The provision extends the provision deferring recognition of gain to a judicial officer who receives a certificate of divestiture from the Judicial Conference of the United States (or its designee) regarding the divestiture of certain property reasonably necessary to comply with

conflict of interest rules or the judicial canon. For purposes of this provision, a judicial officer means the Chief Justice of the United States, the Associate Justices of the Supreme Court, and the judges of the United States courts of appeals, United States district courts, including the district courts in Guam, the Northern Mariana Islands, and the Virgin Islands, Court of Appeals for the Federal Circuit, Court of International Trade, Tax Court, Court of Federal Claims, Court of Appeals for Veterans Claims, United States Court of Appeals for the Armed Forces, and any court created by Act of Congress, the judges of which are entitled to hold office during good behavior.

Effective date.—The provision applies to sales and exchanges after the date of enactment.

19. Premiums for mortgage insurance (sec. 163 of the Code)

Present Law

Present law provides that qualified residence interest is deductible notwithstanding the general rule that personal interest is nondeductible (sec. 163(h)).

Qualified residence interest is interest on acquisition indebtedness and home equity indebtedness with respect to a principal and a second residence of the taxpayer. The maximum amount of home equity indebtedness is \$100,000. The maximum amount of acquisition indebtedness is \$1 million. Acquisition indebtedness means debt that is incurred in acquiring constructing, or substantially improving a qualified residence of the taxpayer, and that is secured by the residence. Home equity indebtedness is debt (other than acquisition indebtedness) that is secured by the taxpayer's principal or second residence, to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.

Explanation of Provision

The provision provides that premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness on a qualified residence of the taxpayer are treated as interest that is qualified residence interest and thus deductible. The amount allowable as a deduction under the provision is phased out ratably by 10 percent for each \$1,000 by which the taxpayer's adjusted gross income exceeds \$100,000 (\$500 and \$50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer's adjusted gross income exceeds \$110,000 (\$55,000 in the case of married individual filing a separate return).

For this purpose, qualified mortgage insurance means mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, or the Rural Housing Administration, and private mortgage insurance (defined in section 2 of the Homeowners Protection Act of 1998 as in effect on the date of enactment of the provision).

Amounts paid for qualified mortgage insurance that are properly allocable to periods after the close of the taxable year are treated as paid in the period to which they are allocated. No deduction is allowed for the unamortized balance if the mortgage is paid before its term (except

in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Administration).

The provision does not apply with respect to any mortgage insurance contract issued before January 1, 2007. The provision terminates for any amount paid or accrued after December 21, 2007, or properly allocable to any period after that date.

Reporting rules apply under the provision.

Effective date.—The provision is effective for amounts paid or accrued after December 31, 2006.

20. Exempt use of kerosene for aviation purposes (sec. 6427 of the Code)

Present Law

Nontaxable uses of kerosene

In general, if kerosene on which tax has been imposed is used by any person for a nontaxable use, a refund in an amount equal to the amount of tax imposed may be obtained either by the purchaser, or in specific cases, the registered ultimate vendor of the kerosene.¹¹⁴ However, the 0.1 cent per gallon representing the Leaking Underground Storage Tank Trust Fund financing rate generally is not refundable, except for exports.¹¹⁵

A nontaxable use is any use which is exempt from the tax imposed by section 4041(a)(1) other than by reason of a prior imposition of tax.¹¹⁶ Nontaxable uses of kerosene include:

- Use on a farm for farming purposes;¹¹⁷
- Use in foreign trade or trade between the United States and any of its possessions;¹¹⁸
- Use as a fuel in vessels and aircraft owned by the United States or any foreign nation and constituting equipment of the armed forces thereof;¹¹⁹
- Exclusive use of a state or local government;¹²⁰

¹¹⁴ Sec. 6427(l).

¹¹⁵ Sec. 6430.

¹¹⁶ Sec. 6427(l)(2).

¹¹⁷ Sec. 4041(f).

¹¹⁸ Sec. 4041(g)(1).

¹¹⁹ Id.

- Export or shipment to a possession of the United States;¹²¹
- Exclusive use of a nonprofit educational organization;¹²²
- Use as a fuel in an aircraft museum for the procurement, care, or exhibition of aircraft of the type used for combat or transport in World War II;¹²³ and
- Use as a fuel in (a) helicopters engaged in the exploration for or the development or removal of hard minerals, oil, or gas and in timber (including logging) operations if the helicopters neither take off from nor land at a facility eligible for Airport Trust Fund assistance or otherwise use federal aviation services during flights or (b) any air transportation for the purpose of providing emergency medical services (1) by helicopter or (2) by a fixed-wing aircraft equipped for and exclusively dedicated on that flight to acute care emergency medical services.¹²⁴
- Off-highway business use.

Since 4041(a) is limited to the delivery into the fuel supply tank of a diesel-powered highway vehicle or train, kerosene delivered into the fuel supply tank of aircraft is a nontaxable use for purposes of section 4041(a).

Claims for refund of kerosene used in aviation

“Commercial aviation” is the use of an aircraft in a business of transporting persons or property for compensation or hire by air, with certain exceptions.¹²⁵ All other aviation is noncommercial aviation.

For fuel not removed directly into the wing of an airplane, the Safe, Accountable, Flexible, Efficient, Transportation Equity Act: A Legacy for Users (“SAFETEA”) changed the rate of taxation for aviation-grade kerosene from 21.8 cents per gallon to the general kerosene and diesel rate of 24.3 cents per gallon.¹²⁶ In order to preserve the aviation rate for fuel actually used in aviation, the 21.8 cent rate of taxation (or as the case may be, the 4.3 cent commercial

¹²⁰ Sec. 4041(g)(2).

¹²¹ Sec. 4041(g)(3).

¹²² Sec. 4041(g)(4).

¹²³ Sec. 4041(h).

¹²⁴ Secs. 4041(l), 4261(f) and (g).

¹²⁵ “Commercial aviation” does not include aircraft used for skydiving, small aircraft on nonestablished lines or transportation for affiliated group members.

¹²⁶ Sec. 11161 of Pub. L. No. 109-59 (2005).

aviation rate, or the nontaxable use rate) is achieved through a refund when the fuel is used in aviation (a refund of 2.5 cents for taxable noncommercial aviation, 20 cents in the case of commercial aviation, and 24.3 cents for nontaxable uses).¹²⁷ These changes became effective on October 1, 2005.

Prior to October 1, 2005, if fuel that was previously taxed was used in noncommercial aviation for a nontaxable use, generally, the ultimate purchaser of such fuel (other than for the exclusive use of a State or local government, or for use on a farm for farming purposes) could claim a refund for the tax that was paid. SAFETEA eliminated the ability of a purchaser to file for a refund with respect to fuel used in noncommercial aviation. Instead, the registered ultimate vendor is the exclusive party entitled to a refund with respect to kerosene used in noncommercial aviation.¹²⁸ An ultimate vendor is the person who sells the kerosene to an ultimate purchaser for use in noncommercial aviation. If the fuel was used for a nontaxable use, the vendor may make a claim for 24.3 cents per gallon, otherwise, the vendor is permitted to claim 2.5 cents per gallon for kerosene sold for use in noncommercial aviation.¹²⁹

For commercial aviation, the ultimate purchaser has the option of filing a claim itself, or waiving the right to refund to its ultimate vendor, if the vendor agrees to file on behalf of the purchaser.¹³⁰

A separate special rule also applies to kerosene sold to a State or local government, regardless of whether the kerosene was sold for aviation or other purposes.¹³¹ In general, this rule makes the registered ultimate vendor the appropriate party for filing refund claims on behalf of a State or local government. Special rules apply for credit card sales.¹³²

¹²⁷ Sec. 6427(l)(1), (4) and (5).

¹²⁸ Sec. 6427(l)(5)(B).

¹²⁹ Sec. 6427(l)(5)(A). Under this provision, of the 24.4 cents of tax imposed on kerosene used in taxable noncommercial aviation, the 0.1 cent for the Leaking Underground Storage Tank Trust Fund financing rate and 21.8 cents of the tax imposed on kerosene cannot be refunded. The limitations of sec. 6427(l)(5)(A) on the amount that cannot be refunded do not apply to uses exempt from tax. However, sec. 6430 prevents a refund of the Leaking Underground Storage Tank Trust Fund financing rate in all cases except export. Sec. 6427(l)(5)(B) requires that all amounts that would have been paid to the ultimate purchaser pursuant to sec. 6427(l)(1) are to be paid to the ultimate registered vendor, therefore the ultimate registered vendor is the only claimant for both nontaxable and taxable use of kerosene in noncommercial aviation.

¹³⁰ Sec. 6427(l)(4)(B).

¹³¹ Sec. 6427(l)(6).

¹³² If certain conditions are met, a registered credit card issuer may make the claim for refund in place of the ultimate vendor. If the diesel fuel or kerosene is purchased with a credit card issued to a State but the credit card issuer is not registered with the IRS (or does not meet certain other conditions) the credit card issuer must collect the amount of the tax and the State is the proper claimant.

Explanation of Provision

In general

The provision allows purchasers that use kerosene for an exempt aviation purpose (other than in the case of a State or local government) to make a claim for refund of the tax that was paid on such fuel or waive their right to claim a refund to their registered ultimate vendors. As a result, under the provision, crop-dusters, air ambulances, aircraft engaged in foreign trade and other exempt users may either make the claim for refund of the 24.3 cents per gallon themselves or waive the right to their vendors.

General noncommercial aviation use (which is entitled to a refund of 2.5 cents-per-gallon) remains an exclusive ultimate vendor rule. The rules for State and local governments also are unchanged.

Special rule for purchases of kerosene used in aviation on a farm for farming purposes

For kerosene used in aviation on a farm for farming purposes that was purchased after December 31, 2004, and before October 1, 2005, the Secretary is to pay to the ultimate purchaser (without interest) an amount equal to the aggregate amount of tax imposed on such fuel, reduced by any payments made to the ultimate vendor of such fuel. Such claims must be filed within 3 months of the date of enactment and may not duplicate claims filed under section 6427(l).

Effective date.—In general, the provision is effective for kerosene sold after September 30, 2005. For kerosene used for an exempt aviation purpose eligible for the waiver rule created by the provision, the ultimate purchaser is treated as having waived the right to payment and as having assigned such right to the ultimate vendor if the vendor meets the requirements of subparagraph (A), (B) or (D) of section 6416(a)(1). The rule of the preceding sentence applies to kerosene sold after September 30, 2005, and before the date of enactment.

The special rule for kerosene used in aviation on a farm for farming purposes is effective on the date of enactment.

21. Deduction for qualified timber gain (sec. 1203 of the Code)

Present Law

Under present law, if a taxpayer cuts standing timber, the taxpayer may elect to treat the cutting as a sale or exchange eligible for capital gains treatment (sec. 631(a)). Also, if a taxpayer disposes of the timber with a retained economic interest or makes an outright sale of the timber, the gain is eligible for capital gain treatment (sec. 631(b)).

Under present law, for taxable years beginning before January 1, 2011, the maximum rate of tax on the adjusted net capital gain of an individual, estate, or trust is 15 percent. Any adjusted net capital gain which otherwise would be taxed at a 10- or 15-percent rate is taxed at a

5-percent rate (zero for taxable years beginning after 2007). These rates apply for purposes of both the regular tax and the alternative minimum tax.¹³³

For taxable years beginning after December 31, 2010, the maximum rate of tax on the adjusted net capital gain of an individual, estate, or trust is 20 percent. Any adjusted net capital gain which otherwise would otherwise be taxed at a 10- or 15-percent rate is taxed at a 10-percent rate. In addition, any gain from the sale or exchange of property held more than five years that would otherwise have been taxed at the 10-percent rate was taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, which would otherwise have been taxed at a 20-percent rate was taxed at an 18-percent rate.

The net capital gain of a corporation is taxed at the same rates as ordinary income, up to a maximum rate of 35 percent.

Explanation of Provision

The provision allows a taxpayer to elect to deduct an amount equal to 60 percent of the taxpayer's qualified timber gain (or, if less, the net capital gain) for a taxable year. In the case of an individual, the deduction reduces adjusted gross income. Qualified timber gain means the net gain described in section 631(a) and (b) for the taxable year.

The deduction is allowed in computing the regular tax and the alternative minimum tax (including the adjusted current earnings of a corporation).

If a taxpayer elects the deduction, the 40 percent of the gain subject to tax is taxed at ordinary income tax rates.¹³⁴

In the case of a pass-thru entity, the election may be made separately by each taxpayer subject to tax on the gain. The Treasury Department may prescribe rules appropriate to apply this provision to gain taken into account by a pass-thru entity.

Effective date.—The provision applies to dispositions of timber after the date of enactment of the provision and before January 1, 2008.

¹³³ Because the entire amount of the capital gain is included in alternative minimum taxable income ("AMTI"), for taxpayers subject to the alternative minimum tax with AMTI in excess of \$112,500 (\$150,000 in the case of a joint return), the gain may cause a reduction in the minimum tax exemption amount and thus effectively tax the gain at rates of 21.5 or 22 percent. Also the gain may cause the phase-out of certain benefits in computing the regular tax.

¹³⁴ Under the provision, because only 40 percent of the gain is included in adjusted gross income and AMTI, only that amount of gain would result in the phase-out of tax benefits.

22. Credit to holders of rural renaissance bonds (new sec. 54A of the Code)

Present Law

In general

Interest on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes if the proceeds of such bonds are used to finance direct activities of governmental units or if such bonds are repaid with revenues of governmental units. These bonds are called “governmental bonds.” Interest on State or local government bonds issued to finance activities of private persons is taxable unless a specific exception applies. These bonds are called “private activity bonds.” The term “private person” generally includes the Federal Government and all other individuals and entities other than States or local governments.

Private activity bonds are eligible for tax-exemption if issued for certain purposes permitted by the Code (“qualified private activity bonds”). Generally, qualified private activity bonds are subject to restrictions on the use of proceeds for the acquisition of land and existing property, use of proceeds to finance certain specified facilities (e.g., airplanes, skyboxes, other luxury boxes, health club facilities, gambling facilities, and liquor stores), and use of proceeds to pay costs of issuance (e.g., bond counsel and underwriter fees). Small issue and redevelopment bonds also are subject to additional restrictions on the use of proceeds for certain facilities (e.g., golf courses and massage parlors). Moreover, the maximum term for qualified private activity bonds generally may not exceed 120 percent of the economic life of the property being financed and certain public approval requirements (similar to requirements that typically apply under State law to issuance of governmental debt) apply under Federal law to issuance of private activity bonds.

Tax-credit bonds

As an alternative to traditional tax-exempt bonds, States and local governments may issue tax-credit bonds for certain purposes. Rather than receiving interest payments, a taxpayer holding a tax-credit bond on an allowance date is entitled to a tax credit. Generally, the credit amount is includible in gross income (as if it were a taxable interest payment on the bond), and the credit may be claimed against regular income tax and alternative minimum tax liability. The following types of tax-credit bonds may be issued under present law: “qualified zone academy bonds,” which are bonds issued for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other personnel at certain school facilities; “clean renewable energy bonds,” which are bonds issued to finance facilities that would qualify for the tax credit under section 45 without regard to the placed in service date requirements of that section; and “gulf tax credit bonds,” which are bonds issued by the States of Louisiana, Mississippi, and Alabama to pay principal, interest, or premium on certain prior bonds.

Arbitrage restrictions on tax-exempt bonds

To prevent States and local governments from issuing more tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the

purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods” before funds are needed for the purpose of the borrowing) or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, profits that are earned during these periods or on such investments must be rebated to the Federal Government. Governmental bonds are subject to less restrictive arbitrage rules than most private activity bonds.

The present-law arbitrage requirements apply to clean renewable energy bonds and gulf tax credit bonds, but do not apply to qualified zone academy bonds.

Explanation of Provision

The provision creates a new category of tax-credit bonds to finance certain projects located in rural areas (“Rural Renaissance Bonds”). As with present law tax-credit bonds, the taxpayer holding Rural Renaissance Bonds on the allowance date is entitled to a tax credit. The amount of the credit is determined by multiplying the bond’s credit rate by the face amount on the holder’s bond. The credit is includible in gross income (as if it were an interest payment on the bond) and could be claimed against regular income tax liability and alternative minimum tax liability.

Under the provision, Rural Renaissance Bonds are defined as any bonds issued by a qualified issuer if, in addition to the requirements discussed below, 95 percent or more of the proceeds of such bonds are used to finance capital expenditures incurred for one or more qualified projects. “Qualified projects” include any of the following projects located in a rural area: (i) a water or waste treatment project, (ii) an affordable housing project, (iii) a community facility project, including hospitals, fire and police stations, and nursing and assisted-living facilities, (iv) a value-added agriculture or renewable energy facility project for agricultural producers or farmer-owned entities, including any project to promote the production, processing, or retail sale of ethanol (including fuel at least 85 percent of the volume of which consists of ethanol), bio-diesel, animal waste, biomass, raw commodities, or wind as a fuel, (v) a distance learning or telemedicine project, (vi) a rural utility infrastructure project, including any electric or telephone system, (vii) a project to expand broadband technology, (viii) a rural teleworks project, and (ix) any of the previously described projects if carried out by the Delta Regional Authority. A “rural area” means any area other than: (1) a city or town which has a population of greater than 50,000 inhabitants or (2) the urbanized area contiguous and adjacent to such a city or town described in (1).

For purposes of the provision, the term “qualified issuer” means any not-for-profit cooperative lender which, as of the date of enactment of this provision, has received a guarantee under the Rural Electrification Act. A qualified issuer must also meet the user fee requirement during the period any Rural Renaissance Bond issued by such qualified issuer is outstanding. The user fee requirement is met if the qualified issuer makes semi-annual grants for qualified projects equal to the outstanding principal of Rural Renaissance Bond issued by such issuer multiplied by one-half the rate on United States Treasury securities of the same maturity.

The provision imposes a maximum maturity limitation on Rural Renaissance Bonds. The maximum maturity is the term which the Secretary estimates will result in the present value of the obligation to repay the principal on any bonds being equal to 50 percent of the face amount of such bond. The provision also requires level amortization of Rural Renaissance Bonds during the period such bonds are outstanding.

To qualify as Rural Renaissance Bonds, the qualified issuer of such bonds must reasonably expect to and actually spend 95 percent or more of the proceeds of such bonds on qualified projects within the five-year period that begins on the date of issuance. To the extent less than 95 percent of the proceeds are used to finance qualified projects during the five-year spending period, bonds will continue to qualify as Rural Renaissance Bonds if unspent proceeds are used within 90 days from the end of such five-year period to redeem any “nonqualified bonds.” For these purposes, the amount of nonqualified bonds is to be determined in the same manner as Treasury regulations under section 142. In addition, the provision provides that the five-year spending period may be extended by the Secretary if the qualified issuer establishes that the failure to satisfy such period is due to reasonable cause and the related projects will continue to proceed with due diligence.

Under the provision, Rural Renaissance Bonds are subject to the arbitrage requirements of section 148 that apply to traditional tax-exempt bonds. Principles under section 148 and the regulations thereunder shall apply for purposes of determining the yield restriction and arbitrage rebate requirements applicable to Rural Renaissance Bonds. For example, for arbitrage purposes, the yield on an issue of Rural Renaissance Bonds is computed by taking into account all payments of interest, if any, on such bonds, i.e., whether the bonds are issued at par, premium, or discount. However, for purposes of determining yield, the amount of the credit allowed to a taxpayer holding Rural Renaissance Bonds is not treated as interest, although such credit amount is treated as interest income to the taxpayer.

Rural Renaissance Bonds must be designated as such by the qualified issuer and must be issued in registered form. The provision also requires issuers of Rural Renaissance Bonds to report issuance to the IRS in a manner similar to that required for tax-exempt bonds. There is a national limitation of \$200 million of Rural Renaissance Bonds that the Secretary may allocate, in the aggregate, to qualified projects. The authority to issue Rural Renaissance Bonds expires December 31, 2009.

Effective date.—The provision is effective for bonds issued after the date of enactment and before January 1, 2010.

23. Deduction for travel expenses for spouse accompanying taxpayer on business travel (sec. 274(m)(3) of the Code)

Present Law

Section 274 includes rules regarding the deductibility of certain entertainment expenses otherwise deductible as business expenses. Under present law, no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement or recreation, unless the taxpayer establishes that the item was directly related to (or, in certain cases,

associated with) the active conduct of the taxpayer's trade or business, or (2) a facility (e.g., an airplane) used in connection with such activity.¹³⁵ No deduction is allowed for travel expenses paid or incurred with respect to a spouse, dependent, or other individual accompanying the taxpayer (or an officer or employee of the taxpayer) on business travel unless (1) the spouse, dependent, or other individual is an employee of the taxpayer; (2) the travel of the spouse, dependent, or other individual is for a bona fide business purpose; and (3) the expenses would otherwise be deductible by the spouse, dependent, or other individual.¹³⁶

Explanation of Provision

The provision repeals the present-law rule disallowing a deduction for travel expenses paid or incurred with respect to a spouse or other individual accompanying the taxpayer on business travel. Thus, under the provision, the deductibility of such amounts is determined under the rules otherwise applicable under sections 162 and 274.

Effective date.—The provision is effective for amounts paid or incurred after the date of enactment and before January 1, 2008.

24. Tax technical corrections

The bill includes technical corrections to recently enacted tax legislation. Except as otherwise provided, the amendments made by the technical corrections contained in the bill take effect as if included in the original legislation to which each amendment relates.

Amendment Related to the Tax Increase Prevention and Reconciliation Act of 2005

Look-through treatment and regulatory authority (Act sec. 103(b)).—Under the Act, for taxable years beginning after 2005 and before 2009, dividends, interest (including factoring income which is treated as equivalent to interest under sec. 954(c)(1)(E)), rents, and royalties received by one controlled foreign corporation (“CFC”) from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to non-subpart F income of the payor (the “TIPRA look-through rule”). The Act further provides that the Secretary shall prescribe such regulations as are appropriate to prevent the abuse of the purposes of the rule.

Section 952(b) provides that subpart F income of a CFC does not include any item of income from sources within the United States which is effectively connected with the conduct by such CFC of a trade or business within the United States (“ECI”) unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a tax treaty. Thus, for example, a payment of interest from a CFC all of the income of which is U.S.-source ECI (and therefore not subpart F income) may receive the unintended benefit of the TIPRA look-through rule under the Act, even though the payment may be deductible for U.S. tax purposes.

¹³⁵ Sec. 274(a).

¹³⁶ Sec. 274(m)(3).

The provision conforms the TIPRA look-through rule to the rule's purpose of allowing U.S. companies to redeploy their active foreign earnings (i.e., CFC earnings subject to U.S. tax deferral) without an additional tax burden in appropriate circumstances. Under the provision, in order to be excluded from foreign personal holding company income under the TIPRA look-through rule, the dividend, interest, rent, or royalty also must not be attributable or properly allocable to income of the related party payor that is treated as ECI. Thus, for example, a payment of interest made by a CFC does not qualify under the TIPRA look-through rule to the extent that the interest payment is allocated to the CFC's ECI.

The provision also clarifies the authority of the Secretary to issue regulations under the TIPRA look-through rule, as amended by this provision. It is intended that the Secretary will prescribe regulations that are necessary or appropriate to carry out the amended TIPRA look-through rule, including, but not limited to, regulations that prevent the inappropriate use of the amended TIPRA look-through rule to strip income from the U.S. income tax base. Regulations issued pursuant to this authority may, for example, include regulations that prevent the application of the amended TIPRA look-through rule to interest deemed to arise under certain related party factoring arrangements pursuant to section 864(d), or under other transactions the net effect of which is the deduction of a payment, accrual, or loss for U.S. tax purposes without a corresponding inclusion in the subpart F income of the CFC income recipient, where such inclusion would have resulted in the absence of the amended TIPRA look-through rule.

Amendment related to the American Jobs Creation Act of 2004

Modification of effective date of exception from interest suspension rules for certain listed and reportable transactions (Act sec. 903).—Section 903 of the American Jobs Creation Act of 2004 (“AJCA”), as modified by section 303 of the Gulf Opportunity Zone Act of 2005, provides that the Secretary of the Treasury may permit interest suspension where taxpayers have acted reasonably and in good faith. For provisions that are included in the Code, section 7701(a)(11) provides that the term “Secretary of the Treasury” means the Secretary in his non-delegable capacity, and the term “Secretary” means the Secretary or his delegate. However, section 903 of AJCA (as modified) is not included in the Code. To clarify that the Secretary may delegate authority under section 903 of AJCA (as modified), the provision adds the words “or the Secretary’s delegate” following the reference to the Secretary of the Treasury.

III. SURFACE MINING CONTROL AND RECLAMATION ACT AMENDMENTS OF 2006

A. Mining Control and Reclamation

The provision includes modifications to the Abandoned Mine Land Trust Fund and other changes.

B. Coal Industry Retiree Health Benefit Act

1. Prepayment of Premium Liability for Coal Industry Health Benefits (secs. 9701, 9704, 9711, and 9712 of the Code)

Present Law

The United Mine Workers of America (“UMWA”) Combined Benefit Fund was established by the Coal Industry Retiree Health Benefit Act of 1992 (the “Coal Act”) to assume responsibility of payments for medical care expenses of retired miners and their dependents who were eligible for health care from the private 1950 and 1974 UMWA Benefit Plans. The Combined Benefit Fund is financed by assessments on current and former signatories to labor agreements with the UMWA, past transfers from an overfunded United Mine Workers pension fund, and transfers from the Abandoned Mine Reclamation Fund. The Social Security Administration is responsible for assigning eligible retired miners and their dependents to current and former signatories to labor agreements with the UMWA and calculating annual contributions to be paid by each such signatory for each beneficiary assigned to the signatory. The Coal Act uses the term “assigned operator” to refer to the signatory to which liability for a particular beneficiary of the Combined Benefit Fund has been assigned. Under the Coal Act, related persons¹³⁷ to signatories to the relevant labor agreements may have joint and several liability for premium payments. A related person operator includes a member of the same controlled group of corporations as a signatory, a trade or business which is under common control with such signatory, any other person who is identified as having a partnership interest or joint venture with a signatory. A successor in interest to a related person is considered a related person with respect to the signatory operator.

Additionally, continuation of certain individual coal industry employer plans is required under the Coal Act. The most recent coal industry employer (the “last signatory operator”) of a coal industry retiree who, as of February 1, 1993, was receiving retiree health benefits from an individual employer plan maintained pursuant to a 1978 or subsequent coal wage agreement is required to continue to provide health benefits coverage to such individual and his or her eligible beneficiaries which is substantially the same as (and subject to all the limitations of) the coverage provided by such plan as of January 1, 1992.¹³⁸ The related persons of a last signatory

¹³⁷ Sec. 9701(c)(2).

¹³⁸ Sec. 9711(a).

operator which is required to provide such health benefits coverage is jointly and severally liable with the last signatory operator for such coverage.

The Coal Act also established the 1992 UMWA Benefit Plan to provide health benefits to individuals not receiving benefits from either the Combined Benefit Fund or individual employer plans.¹³⁹ Joint and several liability also applies to related persons of last signatory operators for amounts required to be paid to the 1992 UMWA Benefit Plan.

Explanation of Provision

The provision allows certain assigned operators to prepay their premium liability to the Combined Benefit Fund. The prepayment is available only if (1) the assigned operator (or a related person) made contributions to the 1950 UMWA Benefit Plan and the 1974 UMWA Benefit Plan for employment during the period covered by an 1988 agreement and is not a 1988 agreement operator; (2) the assigned operator (and all related persons) are not in the coal production business as of July 1, 2005; and (3) the assigned operator was, as of July 20, 1992, a member of a controlled group of corporations the common parent of which is publicly traded. For purposes of this description, an operator that meets these requirements is referred to as an “eligible operator”. Under the provision, only the publicly-traded common parent (and no other person) is liable for the premiums of an assigned operator which is a member of the parent’s controlled group if: (1) a payment to the Combined Benefit Fund meeting certain requirements is made; and (2) the parent is jointly and severally liable for any premium which would otherwise be required to be paid by the operator.

Under the provision, in order for the relief from liability to apply: (1) the payment by the assigned operator (or any related person on behalf of the assigned operator) must be no less than the present value of the total premium liability of the assigned operator (or related persons), as determined by the operator’s enrolled actuary, using actuarial methods and assumptions each of which is reasonable and which are reasonable in the aggregate (as determined by such actuary); and (2) the enrolled actuary must file with the Department of Labor an actuarial report regarding the valuation made by the actuary. The Secretary of Labor has 90 days after the filing of the report to notify the operator if the Secretary believes the applicable requirements have not been satisfied.

The Combined Fund must establish and maintain an account for each assigned operator making a qualified prepayment and must use all amounts in such account exclusively to pay premiums that would otherwise be required to be paid by the assigned operator. Upon termination of the obligations for premium liability of any assigned operator for which such account is maintained, all funds remaining in the account (and earnings thereon) shall be refunded to the entity as designed by the parent of the controlled group (including the assigned operator).

The provision also modifies the rules for joint and several liability of last signatory operators, and related parties to such operators, in the case of individual employer plans under

¹³⁹ Sec. 9712.

Code section 9711. Under the provision, if security meeting certain requirements is provided on behalf of an assigned operator who meets the requirements for an eligible operator, then, as of the date that security is required, the last signatory operator and related persons are relieved of joint and several liability with respect to such last signatory operator if the common parent of the controlled group remains liable for the provision of benefits otherwise required.

The security must be provided to the trustees of the 1992 UMWA Benefit Plan, solely for the purpose of paying premiums for eligible beneficiaries, and must be equal to one year's premium liability of the last signatory operator (determined using the average cost of the operator's liability during the prior three years). The security must remain in place for five years. The remaining amount of any security must be returned upon the earlier of (1) termination of the obligations of the parent or (2) five years. The security must be in the form of a bond, letter of credit, or cash escrow and must be in addition to any otherwise required security.

Similar rules apply in the case of joint and several liability obligations under the 1992 UMWA benefit plan.

Under the provision, successors in interest do not include any person (1) who is an unrelated person to a seller who is an eligible operator (or a related person), and (2) who purchases from such seller, assets, or all of the stock of a related person, for fair market value in a bona fide, arm's-length sale. Thus, such persons are not subject to joint and several liability.

Effective Date

The provisions are generally effective on the date of enactment except that the changes to the definition of successor in interest are effective for transactions after the date of enactment.

2. Other provisions

The provision makes other changes to the Internal Revenue Code, including changes relating to certain premium adjustments, transfers of certain amounts, and the board of trustees of the Combined Fund. The provision also includes other changes.

IV. MINIMUM WAGE PROVISIONS SUMMARY OF EDUCATION AND WORKFORCE PROVISIONS

A. Minimum Wage Increase

Amends the Fair Labor Standards Act to increase the current federal minimum wage rate of \$5.15 per hour by \$2.10 over three years in the following increments: \$5.85 an hour effective on January 1, 2007, \$6.55 an hour effective on June 1, 2008 and \$7.25 an hour effective on June 1, 2009.

B. Tip Credit Fairness

Amends the Fair Labor Standards Act to provide that tips may be counted toward meeting any future minimum-wage increases by employers in those states where state law prohibits tips from being calculated as part of the minimum wage. Current law allows an employer to pay tipped employees at least \$2.13 per hour, provided that the addition of tips equals the federal minimum wage of \$5.15 per hour. If the employee does not earn enough tips to make \$5.15 per hour, then the employer must make up the difference. Several states prohibit employers from counting tips toward meeting their obligation to pay the minimum wage. For those employers, the full minimum wage (federal or state, whichever is higher) must be paid to tipped employees directly by the employer. This disparity between state laws negatively impacts companies that operate nationally, particularly small businesses.