

**DESCRIPTION OF
“A BILL TO ENHANCE ENERGY INFRASTRUCTURE
PROPERTIES IN THE UNITED STATES AND TO
ENCOURAGE THE USE OF CERTAIN
ENERGY TECHNOLOGIES”**

Scheduled for Markup
by the
HOUSE COMMITTEE ON WAYS AND MEANS
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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup on April 13, 2005, on “a bill to enhance energy infrastructure properties in the United States and to encourage the use of certain energy technologies.” This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the bill.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of “A Bill to Enhance Energy Infrastructure Properties in the United States and to Encourage the Use of Certain Energy Technologies”* (JCX-15-05), April 11, 2005.

I. ENERGY INFRASTRUCTURE TAX INCENTIVES

A. Natural Gas Gathering Lines Treated as Seven-Year Property

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the “class life of the property.” The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.² Revenue Procedure 87-56 includes two asset classes either of which could describe natural gas gathering lines owned by nonproducers of natural gas. Asset class 46.0, describing pipeline transportation, provides a class life of 22 years and a recovery period of 15 years. Asset class 13.2, describing assets used in the exploration for and production of petroleum and natural gas deposits, provides a class life of 14 years and a depreciation recovery period of seven years. The uncertainty regarding the appropriate recovery period of natural gas gathering lines has resulted in litigation between taxpayers and the IRS. In each of three recent cases, appellate courts have held that natural gas gathering lines owned by nonproducers fall within the scope of Asset class 13.2 (*i.e.*, seven-year recovery period).³ The appellate court in each case reversed a lower court holding that natural gas gathering lines owned by nonproducers fall within the scope of Asset class 46.0 (*i.e.*, 15-year recovery period). The IRS has not yet indicated whether it acquiesces in the result in these three appellate decisions in cases arising in other circuits.

Description of Proposal

The proposal establishes a statutory seven-year recovery period and a class life of 14 years for natural gas gathering lines. In addition, the proposal provides that there would be no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer’s alternative minimum taxable income with respect to such property. A natural gas gathering line is defined to include any pipe, equipment, and appurtenance that is (1) determined to be a gathering line by the Federal Energy Regulatory Commission, or (2) used to deliver natural gas from the wellhead or a common point to the point at which such gas first reaches (a) a gas processing plant, (b) an interconnection with an interstate transmission line, (c) an interconnection with an intrastate transmission line, or (d) a direct interconnection with a local distribution company, a gas storage facility, or an industrial consumer.

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

³ *Clajon Gas Co, L.P. v. Commissioner*, 354 F.3d 786 (8th Cir. 2004), *rev’g* 119 T.C. 197 (2002); *Saginaw Bay Pipeline Co. v. United States*, 338 F.3d 600 (6th Cir. 2003), *rev’g* 88 A.F.T.R.2d 2001-6019 (E.D. Mich. 2001); *Duke Energy v. Commissioner*, 172 F.3d 1255 (10th Cir. 1999), *rev’g* 109 T.C. 416 (1997).

Effective Date

The proposal is effective for property placed in service after April 11, 2005. No inference is intended as to the proper treatment of natural gas gathering lines placed in service on or before April 11, 2005.

B. Natural Gas Distribution Lines Treated as Fifteen-Year Property

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the “class life of the property.” The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.⁴ Natural gas distribution pipelines are assigned a 20-year recovery period and a class life of 35 years.

Description of Proposal

The proposal establishes a statutory 15-year recovery period and a class life of 35 years for natural gas distribution lines.

Effective Date

The proposal is effective for property placed in service after April 11, 2005.

⁴ 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

C. Transmission Property Treated as Fifteen-Year Property

Present Law

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the “class life of the property.” The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.⁵ Assets used in the transmission and distribution of electricity for sale and related land improvements are assigned a 20-year recovery period and a class life of 30 years.

Description of Proposal

The proposal establishes a statutory 15-year recovery period and a class life of 30 years for certain assets used in the transmission of electricity for sale and related land improvements. For purposes of the proposal, section 1245 property used in the transmission at 69 or more kilovolts of electricity for sale, the original use of which commences with the taxpayer after the date of enactment, will qualify for the new recovery period.

Effective Date

The proposal is effective for property placed in service after April 11, 2005.

⁵ 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

D. Amortization of Atmospheric Pollution Control Facilities

Present Law

In general, a taxpayer may elect to recover the cost of any certified pollution control facility over a period of 60 months.⁶ A certified pollution control facility is defined as a new, identifiable treatment facility which (1) is used in an existing plant in operation before January 1, 1976, to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes or heat; and (2) does not lead to a significant increase in output or capacity, a significant extension of useful life, a significant reduction in total operating costs for such plant or other property (or any unit thereof), or a significant alteration in the nature of a manufacturing production process or facility. Certification is required by appropriate State and Federal authorities that the facility complies with appropriate standards.

For a pollution control facility with a useful life greater than 15 years, only the basis attributable to the first 15 years is eligible to be amortized over a 5-year period.⁷ The remaining basis is depreciable under the regular rules for depreciation. In addition, a corporate taxpayer must reduce the amount of basis eligible for the 60-month recovery by 20 percent.⁸ Such reduction is depreciable under the regular rules for depreciation.

Description of Proposal

The proposal expands the ability to recover the cost of certain certified air pollution control facilities (but not water pollution control facilities) over 60 months by repealing the requirement that only certified pollution control facilities used in connection with a plant in operation before January 1, 1976 qualify. Under the proposal, a certified air pollution control facility which is (1) used in connection with a an electric generation plant which is primarily coal fired, and (2) placed in service after April 11, 2005, will generally be eligible for recovery over 60 months regardless of whether the associated plant or other property was in operation prior to January 1, 1976. The proposal does not alter the present law limitation on the benefits of the provision for corporate taxpayers and pollution control facilities with a useful life greater than 15 years, nor does it modify in any way the treatment of water pollution control facilities.

⁶ Sec. 169. For purposes of the alternative minimum tax, such property is recovered using the straight-line method over its general recovery period (for property placed in service prior to 1999 and after 1986 such property is recovered using the alternative system of depreciation contained in section 168(g)).

⁷ The amount attributable to the first 15 years is equal to an amount which bears the same ratio to the portion of the adjusted basis of such facility, which would be eligible for amortization but for the application of this rule, as 15 bears to the number of years of useful life of such facility.

⁸ Sec. 291(a)(5).

Effective Date

The proposal is effective for air pollution control facilities placed in service after April 11, 2005.

E. Modification of Credit for Producing Fuel From a Non-Conventional Source

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)⁹ per barrel or BTU oil barrel equivalent (“sec. 29 credit”). Qualified fuels must be produced within the United States.

Qualified fuels include:

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

In general, the section 29 credit is available only with respect to fuels produced from wells drilled or facilities placed in service after December 31, 1979, and before January 1, 1993. An exception extends the January 1, 1993 expiration date for facilities producing gas from biomass and synthetic fuel from coal if the facility producing the fuel is placed in service before July 1, 1998, pursuant to a binding contract entered into before January 1, 1997.

The section 29 credit may be claimed for qualified fuels produced and sold before January 1, 2003 (in the case of non-conventional sources subject to the January 1, 1993 expiration date) or January 1, 2008 (in the case of biomass gas and synthetic fuel facilities eligible for the extension period).

The section 29 credit may not exceed the excess of the regular tax liability over the tentative minimum tax. Unused section 29 credits may not be carried forward or carried back to other taxable years. However, to the extent the section 29 credit is disallowed because of the tentative minimum tax, the minimum tax credit allowable in future years is increased by the amount so disallowed.

Other business credits are included in the general business credit (sec. 38). Generally, the general business credit may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability in excess of \$25,000 or (2) the tentative minimum tax. A general business credit in excess of the tax limitation generally may be carried back one year and carried forward 20 years (sec. 39).

⁹ The value of the credit in 2004 was \$6.56 per barrel of oil equivalent produced, which is approximately \$1.16 per thousand cubic feet of natural gas.

Description of Proposal

The proposal makes the credit for producing fuel from a non-conventional source part of the general business credit. Thus, the credit for producing fuel from a non-conventional source will be subject to the limitations applicable to the general business credit. Any unused credits may be carried back one year and forward up to 20 years. The proposal also makes certain clerical changes in cross-references to the Natural Gas Policy Act of 1978, which has been repealed.

Effective Date

The proposal applies to credits determined in taxable years ending after December 31, 2005.¹⁰ The clerical changes are effective on the date of enactment.

¹⁰ No credit may be carried back to a taxable year ending before January 1, 2006 (sec. 39(d)).

F. Modification to Special Rules for Nuclear Decommissioning Costs

Present Law

Overview

Special rules dealing with nuclear decommissioning reserve funds were adopted by Congress in the Deficit Reduction Act of 1984 (“1984 Act”), when tax issues regarding the time value of money were addressed generally. Under general tax accounting rules, a deduction for accrual basis taxpayers is deferred until there is economic performance for the item for which the deduction is claimed. However, the 1984 Act contains an exception under which a taxpayer responsible for nuclear powerplant decommissioning may elect to deduct contributions made to a qualified nuclear decommissioning fund for future decommissioning costs. Taxpayers who do not elect this provision are subject to general tax accounting rules.

Qualified nuclear decommissioning fund

A qualified nuclear decommissioning fund (a “qualified fund”) is a segregated fund established by a taxpayer that is used exclusively for the payment of decommissioning costs, taxes on fund income, management costs of the fund, and for making investments. The income of the fund is taxed at a reduced rate of 20 percent for taxable years beginning after December 31, 1995.¹¹

Contributions to a qualified fund are deductible in the year made to the extent that these amounts were collected as part of the cost of service to ratepayers (the “cost of service requirement”).¹² Funds withdrawn by the taxpayer to pay for decommissioning costs are included in the taxpayer’s income, but the taxpayer also is entitled to a deduction for decommissioning costs as economic performance for such costs occurs.

Accumulations in a qualified fund are limited to the amount required to fund decommissioning costs of a nuclear powerplant for the period during which the qualified fund is in existence (generally post-1984 decommissioning costs of a nuclear powerplant). For this purpose, decommissioning costs are considered to accrue ratably over a nuclear powerplant’s estimated useful life. In order to prevent accumulations of funds over the remaining life of a nuclear powerplant in excess of those required to pay future decommissioning costs of such

¹¹ As originally enacted in 1984, a qualified fund paid tax on its earnings at the top corporate rate and, as a result, there was no present-value tax benefit of making deductible contributions to a qualified fund. Also, as originally enacted, the funds in the trust could be invested only in certain low risk investments. Subsequent amendments to the provision have reduced the rate of tax on a qualified fund to 20 percent and removed the restrictions on the types of permitted investments that a qualified fund can make.

¹² Taxpayers are required to include in gross income customer charges for decommissioning costs (sec. 88).

nuclear powerplant and to ensure that contributions to a qualified fund are not deducted more rapidly than level funding (taking into account an appropriate discount rate), taxpayers must obtain a ruling from the IRS to establish the maximum annual contribution that may be made to a qualified fund (the “ruling amount”). In certain instances (e.g., change in estimates), a taxpayer is required to obtain a new ruling amount to reflect updated information.

A qualified fund may be transferred in connection with the sale, exchange or other transfer of the nuclear powerplant to which it relates. If the transferee is a regulated public utility and meets certain other requirements, the transfer will be treated as a nontaxable transaction. No gain or loss will be recognized on the transfer of the qualified fund and the transferee will take the transferor’s basis in the fund.¹³ The transferee is required to obtain a new ruling amount from the IRS or accept a discretionary determination by the IRS.¹⁴

Nonqualified nuclear decommissioning funds

Federal and State regulators may require utilities to set aside funds for nuclear decommissioning costs in excess of the amount allowed as a deductible contribution to a qualified fund. In addition, taxpayers may have set aside funds prior to the effective date of the qualified fund rules.¹⁵ The treatment of amounts set aside for decommissioning costs prior to 1984 varies. Some taxpayers may have received no tax benefit while others may have deducted such amounts or excluded such amounts from income. Since 1984, taxpayers have been required to include in gross income customer charges for decommissioning costs (sec. 88), and a deduction has not been allowed for amounts set aside to pay for decommissioning costs except through the use of a qualified fund. Income earned in a nonqualified fund is taxable to the fund’s owner as it is earned.

Description of Proposal

Repeal of cost of service requirement

The proposal repeals the cost of service requirement for deductible contributions to a nuclear decommissioning fund. Thus, all taxpayers, including unregulated taxpayers, are allowed a deduction for amounts contributed to a qualified fund.

Permit contributions to a qualified fund for pre-1984 decommissioning costs

The proposal also repeals the limitation that a qualified fund only accumulate an amount sufficient to pay for a nuclear powerplant’s decommissioning costs incurred during the period that the qualified fund is in existence (generally post-1984 decommissioning costs). Thus, any taxpayer is permitted to accumulate an amount sufficient to cover the present value of 100

¹³ Treas. reg. sec. 1.468A-6.

¹⁴ Treas. reg. sec. 1.468A-6(f).

¹⁵ These funds are generally referred to as “nonqualified funds.”

percent of a nuclear powerplant's estimated decommissioning costs in a qualified fund. The proposal does not change the requirement that contributions to a qualified fund not be deducted more rapidly than level funding.

Exception to ruling amount for certain decommissioning costs

The proposal permits a taxpayer to make contributions to a qualified fund in excess of the ruling amount in one circumstance. Specifically, a taxpayer is permitted to contribute up to the present value of total nuclear decommissioning costs with respect to a nuclear powerplant previously excluded under section 468A(d)(2)(A).¹⁶ It is anticipated that an amount that is permitted to be contributed under this special rule shall be determined using the estimate of total decommissioning costs used for purposes of determining the taxpayer's most recent ruling amount. Any amount transferred to the qualified fund under this special rule is allowed as a deduction over the remaining useful life of the nuclear powerplant.¹⁷ If a qualified fund that has received amounts under this rule is transferred to another person, the transferor will be permitted a deduction for any remaining deductible amounts at the time of transfer.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2005.

¹⁶ For example, if \$100 is the present value of the total decommissioning costs of a nuclear powerplant, and if under present law the qualified fund is only permitted to accumulate \$75 of decommissioning costs over such plant's estimated useful life (because the qualified fund was not in existence during 25 percent of the estimated useful life of the nuclear powerplant), a taxpayer could contribute \$25 to the qualified fund under this component of the provision.

¹⁷ A taxpayer recognizes no gain or loss on the contribution of property to a qualified fund under this special rule. The qualified fund will take a transferred (carryover) basis in such property. Correspondingly, a taxpayer's deduction (over the estimated life of the nuclear powerplant) is to be based on the adjusted tax basis of the property contributed rather than the fair market value of such property.

G. Exempt Certain Prepayments for Natural Gas from Tax-Exempt Bond Arbitrage Rules

Present Law

Arbitrage restrictions

Interest on bonds issued by States or local governments to finance activities carried out or paid for by those entities generally is exempt from income tax. Restrictions are imposed on the ability of States or local governments to invest the proceeds of these bonds for profit (the “arbitrage restrictions”).¹⁸ One such restriction limits the use of bond proceeds to acquire “investment-type property.” The term investment-type property includes the acquisition of property in a transaction involving a prepayment if a principal purpose of the prepayment is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. A prepayment can produce prohibited arbitrage profits when the discount received for prepaying the costs exceeds the yield on the tax-exempt bonds. In general, prohibited prepayments include all prepayments that are not customary in an industry by both beneficiaries of tax-exempt bonds and other persons using taxable financing for the same transaction.

On August 4, 2003, the Treasury Department issued final regulations deeming to be customary, and not in violation of the arbitrage rules, certain prepayments for natural gas and electricity.¹⁹ Generally, a qualified prepayment under the regulations requires that 90 percent of the natural gas or electricity purchased with the prepayment be used for a qualifying use. Generally, natural gas is used for a qualifying use if it is to be (1) furnished to retail gas customers of the issuing municipal utility who are located in the natural gas service area of the issuing municipal utility, however, gas used to produce electricity for sale is not included under this provision (2) used by the issuing municipal utility to produce electricity that will be furnished to retail electric service area customers of the issuing utility, (3) used by the issuing municipal utility to produce electricity that will be sold to a utility owned by a governmental person and furnished to the service area retail electric customers of the purchaser, (4) sold to a utility that is owned by a governmental person if the requirements of (1), (2) or (3) are satisfied by the purchasing utility (treating the purchaser as the issuing utility) or (5) used to fuel the pipeline transportation of the prepaid gas supply. Electricity is used for a qualifying use if it is to be (1) furnished to retail service area electric customers of the issuing municipal utility or (2) sold to a municipal utility and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser.

Private activity bond tests

State and local bonds may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance

¹⁸ Sec. 148.

¹⁹ Treas. Reg. sec. 1.148-1(e)(2)(iii).

governmental functions or the debt is repaid with governmental funds. Private activity bonds are bonds where the State or local government serves as a conduit providing financing to private businesses or individuals. A bond will be treated as a private activity bond if more than five percent of the proceeds of the bond issue, or, if less, more than \$5,000,000 is used (directly or indirectly) to make or finance loans to persons other than governmental units (the “private loan financing test”) or if it meets the requirements of a two-part private business test.²⁰

The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain purposes permitted by the Code. Section 141(d) of the Code provides that the term “private activity bond” includes any bond issued as part of an issue if the amount of the proceeds of the issue which are to be used (directly or indirectly) for the acquisition by a governmental unit of nongovernmental output property exceeds the lesser of five percent of such proceeds or \$5 million. “Nongovernmental output property” generally means any property (or interest therein) which before such acquisition was used (or held for use) by a person other than a governmental unit in connection with an output facility (other than a facility for the furnishing of water). An exception applies to output property which is to be used in connection with an output facility 95 percent or more of the output of which will be consumed in (1) a qualified service area of the governmental unit acquiring the property, or (2) a qualified annexed area of such unit.

Description of Proposal

In general

The proposal creates a safe harbor exception to the general rule that tax-exempt bond-financed prepayments violate the arbitrage restrictions. The term “investment type property” does not include a prepayment under a qualified natural gas supply contract. The proposal also provides that such prepayments are not treated as private loans for purposes of the private business tests.

Under the proposal, a prepayment financed with tax-exempt bond proceeds for the purpose of obtaining a supply of natural gas for service area customers of a governmental utility is not treated as the acquisition of investment-type property. A contract is a qualified natural gas contract if the volume of natural gas secured for any year covered by the prepayment does not exceed the sum of (1) the average annual natural gas purchased (other than for resale) by customers of the utility within the service area of the utility (“retail natural gas consumption”) during the testing period, and (2) the amount of natural gas that is needed to fuel transportation

²⁰ Sec. 141(b) and (c). Under the private business test, a bond is a private activity bond if it is part of an issue in which: (1) more than 10 percent of the proceeds of the issue (including use of the bond-financed property) are to be used in the trade or business of any person other than a governmental unit (“private business use”); and (2) more than 10 percent of the payment of principal or interest on the issue is, directly or indirectly, secured by (a) property used or to be used for a private business use or (b) to be derived from payments in respect of property, or borrowed money, used or to be used for a private business use (“private payment test”).

of the natural gas to the governmental utility. The testing period is the 5-calendar-year period immediately preceding the calendar year in which the bonds are issued. A retail customer is one who does not purchase natural gas for resale. Natural gas used to generate electricity by a utility owned by a governmental unit is counted as retail natural gas consumption if the electricity was sold to retail customers within the service area of the governmental electric utility.

Adjustments

The volume of gas permitted by the general rule is reduced by natural gas otherwise available on the date of issuance. Specifically, the amount of natural gas permitted to be acquired under a qualified natural gas contract for any period is to be reduced by the applicable share of natural gas held by the utility on the date of issuance of the bonds and natural gas that the utility has a right to acquire for the prepayment period (determined as of the date of issuance). For purposes of the preceding sentence, “applicable share” means, with respect to any period, the natural gas allocable to such period if the gas were allocated ratably over the period to which the prepayment relates.

For purposes of the safe harbor, if after the close of the testing period and before the issue date of the bonds (1) the government utility enters into a contract to supply natural gas (other than for resale) for a commercial person for use at a property within the service area of such utility and (2) the gas consumption for such property was not included in the testing period or the ratable amount of natural gas to be supplied under the contract is significantly greater than the ratable amount of gas supplied to such property during the testing period, then the amount of gas permitted to be purchased may be increased to accommodate the contract.

The calculation of average annual retail natural gas consumption for purposes of the safe harbor, however, is not to exceed the annual amount of natural gas reasonably expected to be purchased (other than for resale) by persons who are located within the service area of such utility and who, as of the date of issuance of the issue, are customers of such utility.

Intentional acts

The safe harbor does not apply if the utility engages in intentional acts to render (1) the volume of natural gas covered by the prepayment to be in excess of that needed for retail natural gas consumption, and (2) the amount of natural gas that is needed to fuel transportation of the natural gas to the governmental utility.

Definition of service area

Service area is defined as (1) any area throughout which the governmental utility provided (at all times during the testing period) in the case of a natural gas utility, natural gas transmission or distribution services, or in the case of an electric utility, electricity distribution services; (2) limited areas contiguous to such areas, and (3) any area recognized as the service area of the governmental utility under State or Federal law. Contiguous areas are limited to any area within a county contiguous to the area described in (1) in which retail customers of the utility are located if such area is not also served by another utility providing the same service.

Ruling request for higher prepayment amounts

Upon written request, the Secretary may allow an issuer to prepay for an amount of gas greater than that allowed by the safe harbor based on objective evidence of growth in gas consumption or population that demonstrates that the amount permitted by the exception is insufficient.

Nongovernmental output property restrictions

A qualified natural gas supply contract as defined in the proposal is not nongovernmental output property for purposes of subsection (d) of section 141. Subsection (d) of section 141 does not apply to prepayment contracts for natural gas or electricity that either under the Treasury regulations or statutory safe harbor are not investment-type property for purposes of the arbitrage rules under section 148. No inference is intended regarding the application of subsection 141(d) to prepayment contracts not covered by the statutory safe harbor or Treasury regulations.

Application to joint action agencies

In a number of States, joint action agencies serve as purchasing agents for their member municipal gas utilities. The proposal is intended to allow municipal utilities in a State to participate in such buying arrangements as established under State law, subject to the same limitations that would apply if an individual utility were to purchase gas directly. When acting on behalf of its municipal gas utility members, the total amount of gas that can be purchased by a joint action agency under the proposal's exception to the arbitrage rules is the aggregate of what each such member could purchase for itself on a direct basis. Thus, with respect to qualified natural gas supply contracts entered into by joint action agencies for or on behalf of one or more member municipal utilities, the requirements of the safe harbor are tested at the individual municipal utility level based on the amount of gas that would be allocated to such member during any year covered by the contract.

Effective Date

The proposal is effective for obligations issued after date of enactment.

H. Determination of Small Refiner Exception to Oil Depletion Deduction

Present Law

Present law classifies oil and gas producers as independent producers or integrated companies. The Code provides special tax rules for operations by independent producers. One such rule allows independent producers to claim percentage depletion deductions rather than deducting the costs of their asset, a producing well, based on actual production from the well (i.e., cost depletion).

A producer is an independent producer only if its refining and retail operations are relatively small. For example, an independent producer may not have refining operations the runs from which exceed 50,000 barrels on any day in the taxable year during which independent producer status is claimed.²¹ A refinery run is the volume of inputs of crude oil (excluding any product derived from oil) into the refining stream.²²

Description of Proposal

The proposal increases the current 50,000-barrel-per-day limitation to 75,000. In addition, the provision changes the refinery limitation on claiming independent producer status from a limit based on actual daily production to a limit based on average daily production for the taxable year. Accordingly, the average daily refinery runs for the taxable year may not exceed 75,000 barrels. For this purpose, the taxpayer calculates average daily refinery runs by dividing total refinery runs for the taxable year by the total number of days in the taxable year.

Effective Date

The proposal is effective for taxable years ending after date of enactment.

²¹ Sec. 613A(d)(4).

²² Treas. Reg. sec. 1.613A-7(s).

II. MISCELLANEOUS ENERGY TAX INCENTIVES

A. Residential Solar Hot Water Heating, Photovoltaic, and Fuel Cell Credit

Present Law

There is no present-law personal tax credit for residential solar hot water, photovoltaic, or fuel cell property.

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

Description of Proposal

The proposal provides a personal tax credit for the purchase of qualified photovoltaic property and qualified solar water heating property that is used exclusively for purposes other than heating swimming pools and hot tubs. The credit is equal to 15 percent of qualified investment up to a maximum credit of \$2,000 for solar water heating property and \$2,000 for rooftop photovoltaic property. The proposal also provides a 15-percent personal tax credit for the purchase of qualified fuel cell power plants. The credit may not exceed \$500 for each 0.5 kilowatt of capacity. The credit is nonrefundable.²³ The taxpayer's basis in the property is reduced by the amount of the credit.

Qualifying solar water heating property is property that heats water for use in a dwelling unit if at least half of the energy used by such property for such purpose is derived from the sun. Qualified photovoltaic property is property that uses solar energy to generate electricity for use in a dwelling unit. A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that converts a fuel into electricity using electrochemical means, and which has an electricity-only generation efficiency of greater than 30 percent.

To qualify for the credit, the property must be installed on or in connection with a dwelling unit located in the United States and used as a residence by the taxpayer. If less than 80 percent of the use of an item is for nonbusiness purposes, only that portion of the expenditures for such item which is properly allocable to use for nonbusiness purposes shall be taken into account. Certain equipment safety requirements need to be met to qualify for the credit. Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations.

²³ Sec. 301 of the bill allows the credit to offset both the regular tax and the alternative minimum tax.

Effective Date

The credit applies to purchases after the date of enactment in taxable years ending before January 1, 2008.

B. Business Fuel Cell Investment Credit

Present Law

A 10-percent business energy investment tax credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage.

The business energy investment tax credit is a component of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability in excess of \$25,000 or (2) the tentative minimum tax. A general business credit in excess of the tax limitation generally may be carried back one year and carried forward 20 years (sec. 39).

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present-law credit for stationary fuel cell power plant property.

Description of Proposal

The provision provides a 15-percent credit for the purchase of qualified fuel cell power plants for businesses. The credit is part of the business energy investment tax credit.²⁴ A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that converts a fuel into electricity using electrochemical means, and which has an electricity-only generation efficiency of greater than 30 percent. The credit may not exceed \$500 for each 0.5 kilowatt of capacity. The taxpayer's basis in the property is reduced by the amount of the credit claimed.

Effective Date

The proposal applies to property placed in service after April 11, 2005, and before January 1, 2008, under rules similar to rules of section 48(m) of the Internal Revenue Code of 1986 (as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990).

²⁴ Section 302 of the bill provides that the tentative minimum tax is treated as zero for purposes of applying the tax limitation to the portion of the investment tax credit attributable to the credit for fuel cells.

C. Btu-Based Rate for Diesel-Water Fuel Emulsion

Present Law

A 24.3-cents-per-gallon excise tax is imposed on diesel fuel to finance the Highway Trust Fund.²⁵ Gasoline and most special motor fuels are subject to tax at 18.3 cents per gallon for the Trust Fund.²⁶

The statutory rate for certain special motor fuels is determined, on an energy equivalent basis, as follows²⁷:

Liquefied petroleum gas (propane)	13.6 cents per gallon
Liquefied natural gas	11.9 cents per gallon
Methanol derived from natural gas	9.15 cents per gallon
Compressed natural gas	48.54 cents per MCF

No special tax rate is provided for diesel fuel blended with water to form a diesel-water fuel emulsion.

Description of Proposal

A special tax rate of 19.7 cents per gallon is provided for diesel fuel blended with water into a diesel-water fuel emulsion to reflect the reduced Btu content per gallon resulting from the water. Emulsion fuels eligible for the special rate must consist of not more than 83.1 percent diesel (and other minor chemical additives to enhance combustion) and at least 16.9 percent water. The emulsion addition must be registered by a United States manufacturer with the Environmental Protection Agency pursuant to section 211 of the Clean Air Act (as in effect on March 31, 2003). A refund of the difference between the regular rate (24.3 cents per gallon) and the incentive rate (19.7 cents per gallon) is available to the extent tax-paid diesel is used to produce a qualifying emulsion diesel fuel. Anyone who separates the diesel fuel from the diesel-water fuel emulsion on which a reduced rate of tax was imposed is treated as a refiner of the fuel and is liable for the difference between the amount of tax on the latest removal of the separated fuel and the amount of tax that was imposed upon the pre-mixture removal.

Effective Date

The proposal is effective on January 1, 2006.

²⁵ Sec. 4081(a)(2)(A)(iii).

²⁶ Secs. 4081(a)(2)(A)(i) and 4041(a)(2)(B)(i).

²⁷ See sec. 4041(a)(2)(B)(ii) and (iii), sec. 4041(a)(3) and sec. 4041(m)(1)(A).

D. Amortization of Delay Rental Payments

Present Law

Present law generally requires costs associated with inventory and property held for resale to be capitalized rather than currently deducted as they are incurred (sec. 263). Oil and gas producers typically contract for mineral production in exchange for royalty payments. If mineral production is delayed, these contracts provide for “delay rental payments” as a condition of their extension. The Internal Revenue Service has taken the position that the uniform capitalization rules of section 263A require delay rental payments to be capitalized.

Description of Proposal

The proposal allows delay rental payments incurred in connection with the development of oil or gas within the United States to be amortized over two years. In the case of abandoned property, remaining basis may no longer be recovered in the year of abandonment of a property as all basis is recovered over the two-year amortization period.

Effective Date

The proposal applies to amounts paid or incurred in taxable years beginning after the date of enactment. No inference is intended from the prospective effective date of this proposal as to the proper treatment of pre-effective date delay rental payments.

E. Amortization of Geological and Geophysical Expenditures

Present Law

Under present law, geological and geophysical exploration expenditures are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals. Capital expenditures are not currently deductible as ordinary and necessary expenses, but are allocated to the cost of the property (sec. 263). Courts have held, and the Internal Revenue Service has ruled, that geological and geophysical costs are capital expenditures. Thus, the costs attributable to such exploration are allocable to the cost of the property acquired or retained.

Description of Proposal

The proposal allows geological and geophysical amounts incurred in connection with oil and gas exploration in the United States to be amortized over two years. In the case of abandoned property, remaining basis may no longer be recovered in the year of abandonment of a property as all basis is recovered over the two-year amortization period.

Effective Date

The proposal is effective for geological and geophysical costs paid or incurred in taxable years beginning after the date of enactment. No inference is intended from the prospective effective date of this proposal as to the proper treatment of pre-effective date geological and geophysical costs.

F. Advanced Lean-Burn Motor Vehicle Credit

Present Law

Certain costs of qualified clean-fuel vehicle may be expensed and deducted when such property is placed in service (sec. 179A). Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which is methanol, ethanol, any other alcohol or ether).²⁸ The maximum amount of the deduction is \$50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with seating capacities of at least 20 adults; \$5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and \$2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction. The deduction is reduced to 25 percent of the otherwise allowable deduction in 2006 and is unavailable for purchases after December 31, 2006.

Description of Proposal

The proposal provides a credit for the purchase of a new advanced lean-burn technology diesel motor vehicle. A qualifying advanced lean-burn technology motor vehicle must meet the Environmental Protection Agency’s Tier II bin 8 emissions standards. In general the proposal provides that the vehicle owner is allowed the credit, unless the owner is a tax-exempt or governmental entity in which case the seller of the vehicle may be allowed the credit. The proposal permits the credit to offset both the regular tax and the alternative minimum tax. Excess credits may be carried forward for up to 20 years. Qualified advanced lean-burn technology motor vehicles are vehicles placed in service before 2008. Table 1, below, shows the amount of the credit for the purchase of an advanced lean-burn technology motor vehicle.

Table 1.–Credit for Qualifying Advanced Lean-Burn Technology Motor Vehicles

Credit	If Fuel Economy of the Vehicle Is:	
	at least	but less than
\$500	125% of base fuel economy	150% of base fuel economy
\$1,000	150% of base fuel economy	175% of base fuel economy
\$1,500	175% of base fuel economy	200% of base fuel economy
\$2,000	200% of base fuel economy	225% of base fuel economy
\$2,500	225% of base fuel economy	250% of base fuel economy
\$3,000	250% of base fuel economy	

²⁸ A hybrid-electric vehicle may qualify as a clean-fuel vehicle under present law.

In addition to the credit amount shown in Table 3, an advanced lean-burn technology automobile or light truck may be eligible for an additional credit of \$250 if the vehicle achieves an estimated lifetime fuel savings between 1,500 and 2,500 gallons of fuel and an additional credit of \$500 if the vehicle achieves an estimated lifetime fuel savings of at least 2,500 gallons of fuel compared to the 2000 model year city fuel economy for the vehicle inertia weight class of the vehicle. Estimated lifetime fuel savings is calculated assuming the vehicle is driven 120,000 miles over its life.

The base fuel economy is the 2000 model year city fuel economy for vehicles by inertia weight class by vehicle type. The “vehicle inertia weight class” is that defined in regulations prescribed by the Environmental Protection Agency for purposes of Title II of the Clean Air Act. Table 4, below, shows the 2000 model year city fuel economy for vehicles by type and by inertia weight class.

Table 4.–2000 Model Year City Fuel Economy

Vehicle Inertia Weight Class (pounds)	Passenger Automobile (miles per gallon)	Light Truck (miles per gallon)
1,500	43.7	37.6
1,750	43.7	37.6
2,000	38.3	33.7
2,250	34.1	30.6
2,500	30.7	28.0
2,750	27.9	25.9
3,000	25.6	24.1
3,500	22.0	21.3
4,000	19.3	19.0
4,500	17.2	17.3
5,000	15.5	15.8
5,500	14.1	14.6
6,000	12.9	13.6
6,500	11.9	12.8
7,000	11.1	12.0
8,500	11.1	12.0

Effective Date

The proposal is effective for property placed in service after the date of enactment.

G. Energy Efficient Improvements to Existing Homes

Present Law

A taxpayer may exclude from income the value of any subsidy provided by a public utility for the purchase or installation of an energy conservation measure. An energy conservation measure means any installation or modification primarily designed to reduce consumption of electricity or natural gas or to improve the management of energy demand with respect to a dwelling unit (sec. 136).

There is no present law credit for energy efficiency improvements to existing homes.

Description of Proposal

The proposal provides a 20-percent credit for the purchase of qualified energy efficiency improvements to existing homes. The maximum credit for a taxpayer with respect to the same dwelling for all taxable years is \$2,000. A qualified energy efficiency improvement is any energy efficiency building envelope component that meets or exceeds the prescriptive criteria for such a component established by the 2000 International Energy Conservation Code as supplemented and as in effect on the date of enactment (or, in the case of metal roofs with appropriate pigmented coatings, meets the Energy Star program requirements), and (1) that is installed in or on a dwelling located in the United States; (2) owned and used by the taxpayer as the taxpayer's principal residence; (3) the original use of which commences with the taxpayer; and (4) such component reasonably can be expected to remain in use for at least five years. The credit is nonrefundable.²⁹

Building envelope components are: (1) insulation materials or systems which are specifically and primarily designed to reduce the heat loss or gain for a dwelling; (2) exterior windows (including skylights) and doors; and (3) metal roofs with appropriate pigmented coatings which are specifically and primarily designed to reduce the heat loss or gain for a dwelling.

The taxpayer's basis in the property is reduced by the amount of the credit. Special rules apply in the case of condominiums and tenant-stockholders in cooperative housing corporations.

In the case of expenditures that exceed \$1,000, certain certification requirements must be met in order to qualify for the credit.

Effective Date

The provision is effective for qualified energy efficiency improvements installed after the date of enactment and before January 1, 2008.

²⁹ Sec. 301 of the bill allows the credit to offset both the regular tax and the alternative minimum tax.

III. ALTERNATIVE MINIMUM TAX RELIEF

A. Allow Nonbusiness Energy Credits Against the Alternative Minimum Tax

Present Law

Present law imposes an alternative minimum tax on individuals in an amount equal to the excess of the tentative minimum tax over the regular tax liability. The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount.

Generally, for taxable years beginning after December 31, 2005, nonrefundable personal credits may not exceed the excess of the regular tax liability over the tentative minimum tax.

Description of Proposal

The proposal allows the personal credits for residential energy efficient property and energy efficient improvements to existing homes to offset both the regular tax and the alternative minimum tax.

Effective Date

The proposal applies to taxable years beginning after December 31, 2005.³⁰

³⁰ For taxable years beginning before January 1, 2006, present law allows all personal credits to offset both the regular tax and the alternative minimum tax.

B. Allow Certain Business Energy Credits Against the Alternative Minimum Tax

Present Law

Present law imposes an alternative minimum tax on individuals and corporations in an amount equal to the excess of the tentative minimum tax over the regular tax liability. The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount.

Generally, business credits may not exceed the excess of the taxpayer's net income tax over the tentative minimum tax (or, if greater, 25 percent of so much of the regular tax liability as exceeds \$25,000). In applying this limitation to certain business energy credits, the tentative minimum tax is treated as being zero. These credits include the alcohol fuels credit and the section 45 credit for electricity produced from a facility placed in service after October 22, 2004, during the first four years of production beginning on the date the facility is placed in service.

Description of Proposal

The proposal expands the list of business energy credits for which the tentative minimum tax is treated as being zero to include (i) the low sulfur diesel fuel production credit, (ii) the marginal oil and gas well production credit, (iii) the portion of the investment credit attributable to qualified fuel cells, and (iv) for taxable years beginning after December 31, 2005, and before January 1, 2008, the enhanced oil recovery credit.

Effective Date

The proposal applies to credits determined for taxable years beginning after December 31, 2005 (in the case of the credit for qualified fuel cells, for taxable years ending after April 11, 2005).