TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN TITLE XV OF H.R. 6, THE "CLEAN RENEWABLE ENERGY AND CONSERVATION TAX ACT OF 2007," AS PASSED BY THE HOUSE OF REPRESENTATIVES ON DECEMBER 6, 2007

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

December 12, 2007
JCX-111-07

CONTENTS

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the revenue provisions contained in the Title XV of H.R. 6, the "Clean Renewable Energy and Conservation Tax Act of 2007," as passed by the House of Representatives on December 6, 2007.

[1] This document may be cited as follows: Joint Committee on Taxation, *"Technical Explanation of the Revenue Provisions Contained in the Title XV of H.R. 6, the "Clean Renewable Energy and Conservation Tax Act of 2007," as passed by the House of Representatives on December 6, 2007,"* (JCX-111-07), December 12, 2007. This document can also be found on our website at www.house.gov/jct.

CLEAN RENEWABLE ENERGY AND CONSERVATION TAX ACT OF 2007

A. Clean Renewable Energy Production Incentives

1. Extension and modification of the credit for the production of electricity from renewable resources (secs. 1501 and 1502 of the bill and sec. 45 of the Code)

Present Law

In general

An income tax credit is allowed for the production of electricity from qualified energy resources at qualified facilities.[2] Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, and qualified hydropower production. Qualified facilities are, generally, facilities that generate electricity using qualified energy resources. To be eligible for the credit, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person.

Credit amounts and credit period

In general

The base amount of the electricity production credit is 1.5 cents per kilowatt-hour (indexed annually for inflation) of electricity produced. The amount of the credit is 2 cents per kilowatt-hour for 2007. A taxpayer may generally claim a credit during the 10-year period commencing with the date the qualified facility is placed in service. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits.

Credit phaseout

The amount of credit a taxpayer may claim is phased out as the market price of electricity exceeds certain threshold levels. The electricity production credit is reduced over a 3 cent phaseout range to the extent the annual average contract price per kilowatt-hour of electricity sold in the prior year from the same qualified energy resource exceeds 8 cents (adjusted for inflation; 10.7 cents for 2007).

Reduced credit periods and credit amounts

Generally, in the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), geothermal energy facilities, solar energy facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities placed in service before

[2] Sec. 45. In addition to the electricity production credit, section 45 also provides income tax credits for the production of Indian coal and refined coal at qualified facilities. Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

August 8, 2005, the 10-year credit period is reduced to five years commencing on the date the facility was originally placed in service. However, for qualified open-loop biomass facilities (other than a facility described in sec. 45(d)(3)(A)(i) that uses agricultural livestock waste nutrients) placed in service before October 22, 2004, the five-year period commences on January 1, 2005. In the case of a closed-loop biomass facility modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the credit period begins no earlier than October 22, 2004.

In the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), small irrigation power facilities, landfill gas facilities, trash combustion facilities, and qualified hydropower facilities the otherwise allowable credit amount is 0.75 cent per kilowatt-hour, indexed for inflation measured after 1992 (currently 1 cent per kilowatt-hour for 2007).

Other limitations on credit claimants and credit amounts

In general, in order to claim the credit, a taxpayer must own the qualified facility and sell the electricity produced by the facility to an unrelated party. A lessee or operator may claim the credit in lieu of the owner of the qualifying facility in the case of qualifying open-loop biomass facilities and in the case of closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass. In the case of a poultry waste facility, the taxpayer may claim the credit as a lessee or operator of a facility owned by a governmental unit.

For all qualifying facilities, other than closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the amount of credit a taxpayer may claim is reduced by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits, but the reduction cannot exceed 50 percent of the otherwise allowable credit. In the case of closed-loop biomass facilities modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, there is no reduction in credit by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits.

The credit for electricity produced from renewable sources is a component of the general business credit.[3] Generally, the general business credit for any taxable year may not exceed the amount by which the taxpayer's net income tax exceeds the greater of the tentative minimum tax or so much of the net regular tax liability as exceeds $25,000. Excess credits may be carried back one year and forward up to 20 years.

A taxpayer's tentative minimum tax is treated as being zero for purposes of determining the tax liability limitation with respect to 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.

[3] Sec. 38(b)(8).

Qualified facilities

Wind energy facility

A wind energy facility is a facility that uses wind to produce electricity. To be a qualified facility, a wind energy facility must be placed in service after December 31, 1993, and before January 1, 2009.

Closed-loop biomass facility

A closed-loop biomass facility is a facility that uses any organic material from a plant which is planted exclusively for the purpose of being used at a qualifying facility to produce electricity. In addition, a facility can be a closed-loop biomass facility if it is a facility that is modified to use closed-loop biomass to co-fire with coal, with other biomass, or with both coal and other biomass, but only if the modification is approved under the Biomass Power for Rural Development Programs or is part of a pilot project of the Commodity Credit Corporation.

To be a qualified facility, a closed-loop biomass facility must be placed in service after December 31, 1992, and before January 1, 2009. In the case of a facility using closed-loop biomass but also co-firing the closed-loop biomass with coal, other biomass, or coal and other biomass, a qualified facility must be originally placed in service and modified to co-fire the closed-loop biomass at any time before January 1, 2009.

Open-loop biomass (including agricultural livestock waste nutrients) facility

An open-loop biomass facility is a facility that uses open-loop biomass to produce electricity. For purposes of the credit, open-loop biomass is defined as (1) any agricultural livestock waste nutrients or (2) any solid, nonhazardous, cellulosic waste material or any lignin material that is segregated from other waste materials and which is derived from:

- forest-related resources, including mill and harvesting residues, precommercial thinnings, slash, and brush;
- solid wood waste materials, including waste pallets, crates, dunnage, manufacturing and construction wood wastes, and landscape or right-of-way tree trimmings; or
- agricultural sources, including orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues.

Agricultural livestock waste nutrients are defined as agricultural livestock manure and litter, including bedding material for the disposition of manure. Wood waste materials do not qualify as open-loop biomass to the extent they are pressure treated, chemically treated, or painted. In addition, municipal solid waste, gas derived from the biodegradation of solid waste, and paper which is commonly recycled do not qualify as open-loop biomass. Open-loop biomass does not include closed-loop biomass or any biomass burned in conjunction with fossil fuel (co-firing) beyond such fossil fuel required for start up and flame stabilization.

In the case of an open-loop biomass facility that uses agricultural livestock waste nutrients, a qualified facility is one that was originally placed in service after October 22, 2004, and before January 1, 2009, and has a nameplate capacity rating which is not less than 150 kilowatts. In the case of any other open-loop biomass facility, a qualified facility is one that was originally placed in service before January 1, 2009.

Geothermal facility

A geothermal facility is a facility that uses geothermal energy to produce electricity. Geothermal energy is energy derived from a geothermal deposit that is a geothermal reservoir consisting of natural heat that is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure). To be a qualified facility, a geothermal facility must be placed in service after October 22, 2004, and before January 1, 2009.

Solar facility

A solar facility is a facility that uses solar energy to produce electricity. To be a qualified facility, a solar facility must be placed in service after October 22, 2004, and before January 1, 2006.

Small irrigation facility

A small irrigation power facility is a facility that generates electric power through an irrigation system canal or ditch without any dam or impoundment of water. The installed capacity of a qualified facility must be at least 150 kilowatts but less than five megawatts. To be a qualified facility, a small irrigation facility must be originally placed in service after October 22, 2004, and before January 1, 2009.

Landfill gas facility

A landfill gas facility is a facility that uses landfill gas to produce electricity. Landfill gas is defined as methane gas derived from the biodegradation of municipal solid waste. To be a qualified facility, a landfill gas facility must be placed in service after October 22, 2004, and before January 1, 2009.

Trash combustion facility

Trash combustion facilities are facilities that burn municipal solid waste (garbage) to produce steam to drive a turbine for the production of electricity. To be a qualified facility, a trash combustion facility must be placed in service after October 22, 2004, and before January 1, 2009. A qualified trash combustion facility includes a new unit, placed in service after October 22, 2004, that increases electricity production capacity at an existing trash combustion facility. A new unit generally would include a new burner/boiler and turbine. The new unit may share certain common equipment, such as trash handling equipment, with other pre-existing units at the same facility. Electricity produced at a new unit of an existing facility qualifies for the production credit only to the extent of the increased amount of electricity produced at the entire facility.

Hydropower facility

A qualifying hydropower facility is (1) a facility that produced hydroelectric power (a hydroelectric dam) prior to August 8, 2005, at which efficiency improvements or additions to capacity have been made after such date and before January 1, 2009, that enable the taxpayer to produce incremental hydropower or (2) a facility placed in service before August 8, 2005, that did not produce hydroelectric power (a nonhydroelectric dam) on such date, and to which turbines or other electricity generating equipment have been added after such date and before January 1, 2009.

At an existing hydroelectric facility, the taxpayer may claim credit only for the production of incremental hydroelectric power. Incremental hydroelectric power for any taxable year is equal to the percentage of average annual hydroelectric power produced at the facility attributable to the efficiency improvement or additions of capacity determined by using the same water flow information used to determine an historic average annual hydroelectric power production baseline for that facility. The Federal Energy Regulatory Commission will certify the baseline power production of the facility and the percentage increase due to the efficiency and capacity improvements.

At a nonhydroelectric dam, the facility must be licensed by the Federal Energy Regulatory Commission and meet all other applicable environmental, licensing, and regulatory requirements and the turbines or other generating devices must be added to the facility after August 8, 2005 and before January 1, 2009. In addition, there must not be any enlargement of the diversion structure, construction or enlargement of a bypass channel, or the impoundment or any withholding of additional water from the natural stream channel.

Summary of credit rate and credit period by facility type

Table 1.–Summary of Section 45 Credit for Electricity Produced from Certain Renewable Resources

Eligible electricity production activity	Credit amount for 2007 (cents per kilowatt-hour)	Credit period for facilities placed in service on or before August 8, 2005 (years from placed-in-service date)	Credit period for facilities placed in service after August 8, 2005 (years from placed-in-service date)
Wind	2	10	10
Closed-loop biomass	2	10[1]	10
Open-loop biomass (including agricultural livestock waste nutrient facilities)	1	5[2]	10
Geothermal	2	5	10
Solar (pre-2006 facilities only)	2	5	10
Small irrigation power	1	5	10
Municipal solid waste (including landfill gas facilities and trash combustion facilities)	1	5	10
Qualified hydropower	1	N/A	10

[1] In the case of certain co-firing closed-loop facilities, the credit period begins no earlier than October 22, 2004.
[2] For certain facilities placed in service before October 22, 2004, the five-year credit period commences on January 1, 2005.

Taxation of cooperatives and their patrons

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception: the cooperative may exclude from its taxable income distributions of patronage dividends. Generally, a cooperative that is subject to the cooperative tax rules of subchapter T of the Code[4] is permitted a deduction for patronage dividends paid only to the extent of net income that is derived from transactions with patrons who are members of the cooperative.[5] The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative. For taxable years

[4] Secs. 1381-1383.

[5] Sec. 1382.

ending on or before August 8, 2005, cooperatives may not pass any portion of the income tax credit for electricity production through to their patrons.

For taxable years ending after August 8, 2005, eligible cooperatives may elect to pass any portion of the credit through to their patrons. An eligible cooperative is defined as a cooperative organization that is owned more than 50 percent by agricultural producers or entities owned by agricultural producers. The credit may be apportioned among patrons eligible to share in patronage dividends on the basis of the quantity or value of business done with or for such patrons for the taxable year. The election must be made on a timely filed return for the taxable year and, once made, is irrevocable for such taxable year.

Explanation of Provision

The provision extends and modifies the electricity production credit.

Extension of placed-in-service date for qualifying facilities

The provision extends for four years (through 2012) the period during which qualified facilities producing electricity from wind, closed-loop biomass, open-loop biomass, geothermal energy, small irrigation power, municipal solid waste, and qualified hydropower may be placed in service for purposes of the electricity production credit.

Addition of marine and hydrokinetic renewable energy as a qualified resource

The provision adds marine and hydrokinetic renewable energy as a qualified energy resource and marine and hydrokinetic renewable energy facilities as qualified facilities. Marine and hydrokinetic renewable energy is defined as energy derived from (1) waves, tides, and currents in oceans, estuaries, and tidal areas; (2) free flowing water in rivers, lakes, and streams; (3) free flowing water in an irrigation system, canal, or other man-made channel, including projects that utilize nonmechanical structures to accelerate the flow of water for electric power production purposes; or (4) differentials in ocean temperature (ocean thermal energy conversion). The term does not include energy derived from any source that uses a dam, diversionary structure (except for irrigation systems, canals, and other man-made channels), or impoundment for electric power production. A qualified marine and hydrokinetic renewable energy facility is any facility owned by the taxpayer and placed in service after the date of enactment and before 2014 that produces electric power from marine and hydrokinetic renewable energy and that has a nameplate capacity rating of at least 150 kilowatts.

Under the provision, marine and hydrokinetic renewable energy facilities subsume small irrigation power facilities. The provision, therefore, terminates as a separate category of qualified facility small irrigation power facilities placed in service on or after the date of enactment. Such facilities qualify for the electricity production credit as marine and hydrokinetic renewable energy facilities.

Phaseout replaced by limitation based on investment in facility

The provision replaces the electricity production credit phaseout with an annual limit on the total credits that may be claimed with respect to any qualified facility placed in service after

2008 based on the investment in the facility. Under the limitation, the electricity production credit determined for any taxable year may not exceed the eligible basis of the facility multiplied by a limitation percentage (the "applicable percentage") determined by the Secretary for the month during which the facility is originally placed in service. The applicable percentage for any month is the percentage that yields over a 10-year period amounts of limitation that have a present value equal to 35 percent of the eligible basis of the facility. The discount rate for purposes of this calculation is the greater of 4.5 percent or 110 percent of the long-term Federal rate.

Generally, the eligible basis of a facility is the basis of such facility at the time it is originally placed in service. However, certain special rules apply. Since each wind turbine generally qualifies as a separate facility under section 45, the basis of shared qualified property at a wind project composed of multiple separate wind facilities may be allocated in proportion to the projected generation from such facilities. For this purpose, shared qualified property is property that is eligible for 5-year depreciation under section 168(e)(3)(B)(vi) but which is not part of a qualified facility. In the case of a qualified geothermal facility, the eligible basis for purposes of the limitation includes intangible drilling and development costs described in section 263(c).

At the election of the taxpayer, all qualified facilities which are part of the same project and which are placed in service during the same calendar year may be treated for as a single facility placed in service at either the mid-point of such year or the first day of the following calendar year.

Special rules apply for the first and last year of a facility's 10-year credit period to allocate the limitation across a taxpayer's taxable years. In addition, if a facility's production is less than the limitation amount for any taxable year, the limitation with respect to such facility for the next taxable year is increased by the amount of the unused limitation. Similarly, if the electricity production credit exceeds the limitation amount for any taxable year, but falls under the limit the following year, the credit for the following taxable year is increased, up to that year's limitation amount, by the amount of such excess, but not beyond the facility's 10-year credit eligibility period.

Effective Date

The extension of the electricity production credit and the limitation based on investment are effective for facilities originally placed in service after 2008. The repeal of the credit phaseout adjustment is effective for taxable years ending after 2008. The addition of marine and hydrokinetic renewable energy as a qualified energy resource is effective for electricity produced at qualified facilities and sold after the date of enactment in taxable years ending after such date.

2. Extension and modification of energy credit (sec. 1503 of the bill and sec. 48 of the Code)

Present Law

In general

A nonrefundable, 10-percent business energy credit[6] is allowed for the cost of new property that is equipment that either (1) uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) is 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. Property used to generate energy for the purposes of heating a swimming pool is not eligible solar energy property.

The energy credit is a component of the general business credit[7] and as such is subject to the alternative minimum tax. An unused general business credit generally may be carried back one year and carried forward 20 years.[8] The taxpayer's basis in the property is reduced by one-half of the amount of the credit claimed. For projects whose construction time is expected to equal or exceed two years, the credit may be claimed as progress expenditures are made on the project, rather than during the year the property is placed in service. Similarly, the credit only applies to expenditures made after the effective date of the provision.

In general, property that is public utility property is not eligible for the credit. Public utility property is property that is used predominantly in the trade or business of the furnishing or sale of (1) electrical energy, water, or sewage disposal services, (2) gas through a local distribution system, or (3) telephone service, domestic telegraph services, or other communication services (other than international telegraph services), if the rates for such furnishing or sale have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission. This rule is waived in the case of telecommunication companies' purchases of fuel cell and microturbine property.

Special rules for solar energy property

The credit for solar energy property is increased to 30 percent in the case of periods after December 31, 2005 and prior to January 1, 2009. Additionally, equipment that uses fiber-optic distributed sunlight to illuminate the inside of a structure is solar energy property eligible for the 30-percent credit.

---

[6] Sec. 48.

[7] Sec. 38(b)(1).

[8] Sec. 39.

Fuel cells and microturbines

The business energy credit also applies for the purchase of qualified fuel cell power plants, but only for periods after December 31, 2005 and prior to January 1, 2009. The credit rate is 30 percent.

A qualified fuel cell power plant is an integrated system composed of a fuel cell stack assembly and associated balance of plant components that (1) converts a fuel into electricity using electrochemical means, and (2) has an electricity-only generation efficiency of greater than 30 percent and a capacity of at least on-half kilowatt. The credit may not exceed $500 for each 0.5 kilowatt of capacity.

The business energy credit also applies for the purchase of qualifying stationary microturbine power plants, but only for periods after December 31, 2005 and prior to January 1, 2009. The credit is limited to the lesser of 10 percent of the basis of the property or $200 for each kilowatt of capacity.

A qualified stationary microturbine power plant is an integrated system comprised of a gas turbine engine, a combustor, a recuperator or regenerator, a generator or alternator, and associated balance of plant components that converts a fuel into electricity and thermal energy. Such system also includes all secondary components located between the existing infrastructure for fuel delivery and the existing infrastructure for power distribution, including equipment and controls for meeting relevant power standards, such as voltage, frequency and power factors. Such system must have an electricity-only generation efficiency of not less that 26 percent at International Standard Organization conditions and a capacity of less than 2,000 kilowatts.

Additionally, for purposes of the fuel cell and microturbine credits, and only in the case of telecommunications companies, the general present-law section 48 restriction that would otherwise prohibit telecommunication companies from claiming the new credit due to their status as public utilities is waived.

Explanation of Provision

The provision extends the otherwise expiring credits and credit rates for eight years, through December 31, 2016. The provision raises the $500 per half kilowatt of capacity credit cap with respect to fuel cells to $1500 per half kilowatt of capacity. Also, the restrictions on public utility property being eligible for the credit are repealed. The provision makes the energy credit allowable against the alternative minimum tax.

The provision makes combined heat and power ("CHP") property eligible for the 10-percent energy credit through December 31, 2016.

CHP property is property: (1) that uses the same energy source for the simultaneous or sequential generation of electrical power, mechanical shaft power, or both, in combination with the generation of steam or other forms of useful thermal energy (including heating and cooling applications); (2) that has an electrical capacity of not more than 50 megawatts or a mechanical energy capacity of no more than 67,000 horsepower or an equivalent combination of electrical and mechanical energy capacities; (3) that produces at least 20 percent of its total useful energy in the form of thermal energy that is not used to produce electrical or mechanical power, and produces at least 20 percent of its total useful energy in the form of electrical or mechanical power (or a combination thereof); and (4) the energy efficiency percentage of which exceeds 60 percent. CHP property does not include property used to transport the energy source to the generating facility or to distribute energy produced by the facility.

The otherwise allowable credit with respect to CHP property is reduced to the extent the property has an electrical capacity or mechanical capacity in excess of an applicable limits. Property in excess of the applicable limit (15 megawatts or a mechanical energy capacity of more than 20,000 horsepower or an equivalent combination of electrical and mechanical energy capacities) is permitted to claim a fraction of the otherwise allowable credit. The fraction is equal to the applicable limit divided by the capacity of the property. For example, a 45 megawatt property would be eligible to claim 15/45ths, or one third, of the otherwise allowable credit.

Additionally, the provision provides that systems whose fuel source is at least 90 percent open-loop biomass and that would qualify for the credit but for the failure to meet the efficiency standard are eligible for a credit that is reduced in proportion to the degree to which the system fails to meet the efficiency standard. For example, a system that would otherwise be required to meet the 60-percent efficiency standard, but which only achieves 30-percent efficiency, would be permitted a credit equal to one-half of the otherwise allowable credit (i.e., a 5-percent credit).

Effective Date

The provision is effective on the date of enactment.

3. Credit for residential energy efficient property (sec. 1504 of the bill and sec. 25D of the Code)

Present Law

Code section 25D provides a personal tax credit for the purchase of qualified solar electric 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 30 percent of qualifying expenditures, with a maximum credit for each of these systems of property of $2,000. Section 25D also provides a 30 percent credit for the purchase of qualified fuel cell power plants. The credit for any fuel cell may not exceed $500 for each 0.5 kilowatt of capacity.

Qualifying solar water heating property means an expenditure for property to heat water for use in a dwelling unit located in the United States and used as a residence if at least half of the energy used by such property for such purpose is derived from the sun. Qualified solar electric 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 (1) converts a fuel into electricity using electrochemical means, (2) has an electricity-only generation efficiency of greater than 30 percent. The qualified fuel cell power plant must be installed on or in connection with a dwelling unit located in the United States and used by the taxpayer as a principal residence.

The credit is nonrefundable, and the depreciable basis of the property is reduced by the amount of the credit. Expenditures for labor costs allocable to onsite preparation, assembly, or original installation of property eligible for the credit are eligible expenditures.

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. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

The credit applies to property placed in service prior to January 1, 2009.

Explanation of Provision

The provision extends the credit for six years (through December 31, 2014) and allows the credit to be claimed against the alternative minimum tax. Additionally, the credit cap for solar electric property is raised to $4,000.

The provision provides a new 30 percent credit for qualified small wind energy property expenses made by the taxpayer during the taxable year. The credit is limited to $500 with respect to each half kilowatt of capacity, not to exceed $4,000. The credit for qualified small wind energy property is allowed for expenditures after December 31, 2007, for property placed in service prior to January 1, 2015.

Qualified small wind energy property expenditures are expenditures for property that uses a wind turbine to generate electricity for use in a dwelling unit located in the U.S. and used as a residence by the taxpayer.

Effective Date

The provision is effective for expenditures made after December 31, 2007, for property placed in service prior to January 1, 2015.

4. Extension of special rule to implement FERC restructuring policy (sec. 1505 of the bill and sec. 451(i) of the Code)

Present Law

Generally, a taxpayer selling property recognizes gain to the extent the sales price (and any other consideration received) exceeds the seller's basis in the property. The recognized gain is subject to current income tax unless the gain is deferred or not recognized under a special tax provision.

One such special tax provision permits taxpayers to elect to recognize gain from qualifying electric transmission transactions ratably over an eight-year period beginning in the year of sale if the amount realized from such sale is used to purchase exempt utility property within the applicable period[9] (the "reinvestment property"). If the amount realized exceeds the amount used to purchase reinvestment property, any realized gain is recognized to the extent of such excess in the year of the qualifying electric transmission transaction.

A qualifying electric transmission transaction is the sale or other disposition of property used by the taxpayer in the trade or business of providing electric transmission services, or an ownership interest in such an entity, to an independent transmission company prior to January 1, 2008. In general, an independent transmission company is defined as: (1) an independent transmission provider[10] approved by the FERC; (2) a person (i) who the FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a "market participant" and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider before the close of the period specified in such authorization, but not later than December 31, 2007; or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas State law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).

Exempt utility property is defined as: (1) property used in the trade or business of generating, transmitting, distributing, or selling electricity or producing, transmitting, distributing, or selling natural gas, or (2) stock in a controlled corporation whose principal trade or business consists of the activities described in (1).

If a taxpayer is a member of an affiliated group of corporations filing a consolidated return, the reinvestment property may be purchased by any member of the affiliated group (in lieu of the taxpayer).

Explanation of Provision

The provision extends the treatment under the present-law deferral provision for "qualified electric utilities" to sales or other dispositions before January 1, 2010. For these purposes, a qualified electric utility is a person that, as of the date of the qualifying electric transmission transaction, is vertically integrated, in that it is both (1) a transmitting utility (as defined in section 3(23) of the Federal Power Act (16 U.S.C. 796(23)) with respect to the transmission facilities to which the election applies, and (2) an electric utility (as defined in section 3(22) of the Federal Power Act (16 U.S.C. 796(22)).

The definition of an independent transmission company is modified for taxpayers whose transmission facilities are placed under the operational control of a FERC-approved independent

[9] The applicable period for a taxpayer to reinvest the proceeds is four years after the close of the taxable year in which the qualifying electric transmission transaction occurs.

[10] For example, a regional transmission organization, an independent system operator, or an independent transmission company.

transmission provider, which under the provision must take place no later four years after the close of the taxable year in which the transaction occurs.

The provision also changes the definition of exempt utility property to exclude property that is located outside the United States.

Effective Date

The extension for qualified electric utilities applies to qualifying electric transmission transactions after December 31, 2007. The change in the definition of an independent transmission company is effective as if included in section 909 of the American Jobs Creation Act of 2004. The exclusion for property located outside the United States applies to qualifying electric transmission transactions after the date of enactment.

5. New clean renewable energy bonds (sec. 1506 of the bill and new secs. 54A and 54B 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 the governmental units. Activities that can be financed with these tax-exempt bonds include the financing of electric power facilities (i.e., generation, transmission, distribution, and retailing).

Interest on State or local government bonds to finance activities of private persons ("private activity bonds") is taxable unless a specific exception is contained in the Code (or in non-Code provision of a revenue Act). The term "private person" generally includes the Federal Government and all other individuals and entities other than States or local governments. The Code includes exceptions permitting States or local governments to act as conduits providing tax-exempt financing for certain private activities. In most cases, the aggregate volume of these tax-exempt private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. For calendar year 2007, the State volume cap, which is indexed for inflation, equals $85 per resident of the State, or $256.24 million, if greater.

The tax exemption for State and local bonds also does not apply to any arbitrage bond.[11] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.[12] In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before

[11] Sec. 103(a) and (b)(2).

[12] Sec. 148.

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, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

An issuer must file with the IRS certain information about the bonds issued by them in order for that bond issue to be tax-exempt.[13] 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.

Clean renewable energy bonds

As an alternative to traditional tax-exempt bonds, States and local governments may issue clean renewable energy bonds ("CREBs"). CREBs are defined as any bond 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 by qualified borrowers for qualified projects. "Qualified projects" are facilities that qualify for the tax credit under section 45 (other than Indian coal production facilities), without regard to the placed-in-service date requirements of that section.[14] The term "qualified issuers" includes (1) governmental bodies (including Indian tribal governments); (2) mutual or cooperative electric companies (described in section 501(c)(12) or section 1381(a)(2)(C), or a not-for-profit electric utility which has received a loan or guarantee under the Rural Electrification Act); and (3) clean renewable energy bond lenders. The term "qualified borrower" includes a governmental body (including an Indian tribal government) and a mutual or cooperative electric company. A clean renewable energy bond lender means a cooperative which is owned by, or has outstanding loans to, 100 or more cooperative electric companies and is in existence on February 1, 2002.

Unlike tax-exempt bonds, CREBs are not interest-bearing obligations. Rather, the taxpayer holding CREBs on a credit 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 rate on the bonds is determined by the Secretary and is to be a rate that permits issuance of CREBs without discount and interest cost to the qualified issuer. The credit accrues quarterly and is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability.

CREBs are subject to a maximum maturity limitation. The maximum maturity is the term which the Secretary estimates will result in the present value of the obligation to repay the principal on a CREBs being equal to 50 percent of the face amount of such bond. The discount rate used to determine the present value amount is the average annual interest rate of tax-exempt obligations having a term of 10 years or more which are issued during the month the CREBs are

---

[13] Sec. 149(e).

[14] In addition, Notice 2006-7 provides that qualified projects include any facility owned by a qualified borrower that is functionally related and subordinate to any facility described in sections 45(d)(1) through (d)(9) and owned by such qualified borrower.

issued. In addition, the Code requires level amortization of CREBs during the period such bonds are outstanding.

CREBs also are subject to the arbitrage requirements of section 148 that apply to traditional tax-exempt bonds. Principles under section 148 and the regulations thereunder apply for purposes of determining the yield restriction and arbitrage rebate requirements applicable to CREBs.

In addition to the above requirements, at least 95 percent of the proceeds of CREBs must be spent 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 CREBs if unspent proceeds are used within 90 days from the end of such five-year period to redeem bonds. The five-year spending period may be extended by the Secretary upon the qualified issuer's request demonstrating that the failure to satisfy the five-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

Issuers of CREBs are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds. There is a national CREB limitation of $1.2 billion. The maximum amount of CREBs that may be allocated to qualified projects of governmental bodies is $750 million. CREBs must be issued before January 1, 2009.

Explanation of Provision

The provision creates a new category of clean renewable energy bonds ("New CREBs") that may be issued by qualified issuers to finance qualified renewable energy facilities. Qualified renewable energy facilities are facilities: (1) that qualify for the tax credit under section 45 (other than Indian coal and refined coal production facilities), without regard to the placed-in-service date requirements of that section; and (2) that are owned by a public power provider, governmental bodies, or cooperative electric company.

The term "qualified issuers" includes: (1) public power providers; (2) a governmental body; (3) cooperative electric companies; (4) a not-for-profit electric utility that has received a loan or guarantee under the Rural Electrification Act; and (5) clean renewable energy bond lenders. The term "public power provider" means a State utility with a service obligation, as such terms are defined in section 217 of the Federal Power Act (as in effect on the date of the enactment of this paragraph). A "governmental body" means any State or Indian tribal government, or any political subdivision thereof. The term "cooperative electric company" means a mutual or cooperative electric company (described in section 501(c)(12) or section 1381(a)(2)(C)). A clean renewable energy bond lender means a cooperative that is owned by, or has outstanding loans to, 100 or more cooperative electric companies and is in existence on February 1, 2002.

There is a national limitation for New CREBs of $2 billion. Under the provision, no more than one-third of the national limit may be allocated to projects of public power providers, governmental bodies, or cooperative electric companies. Allocations to governmental bodies and cooperative electric companies may be made in the manner the Secretary determines appropriate. Allocations to projects of public power providers shall be made, to the extent practicable, in such manner that the amount allocated to each such project bears the same ratio to the cost of such project as the maximum allocation limitation to projects of public power providers bears to the cost of all such projects.

Under the provision, 100 percent of the available project proceeds of New CREBs must be used within the three-year period that begins on the date of issuance. The provision defines available project proceeds as proceeds from the sale of the bond issue less issuance costs (not to exceed two percent) and any investment earnings on such sale proceeds. To the extent less than 100 percent of the available project proceeds are used to finance qualified projects during the three-year spending period, bonds will continue to qualify as New CREBs if unspent proceeds are used within 90 days from the end of such three-year period to redeem bonds. The three-year spending period may be extended by the Secretary upon the qualified issuer's request demonstrating that the failure to satisfy the three-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

New CREBs generally are subject to the arbitrage requirements of section 148. However, available project proceeds invested during the three-year spending period are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). In addition, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the New CREBs are issued.

The maturity of New CREBs is the term that the Secretary estimates will result in the present value of the obligation to repay the principal on such bonds being equal to 50 percent of the face amount of such bonds, using as a discount rate the average annual interest rate of tax-exempt obligations having a term of 10 years or more which are issued during the month the qualified energy conservation bonds are issued.

As with present-law CREBs, the taxpayer holding New CREBs on a credit allowance date is entitled to a tax credit. Unlike present-law CREBs, however, the credit rate on New CREBs is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer. The amount of the tax credit is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit accrues quarterly, is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

Issuers of New CREBs are required to certify that the financial disclosure requirements that apply to State and local bonds offered for sale to the general public are satisfied with respect to any Federal, State, or local government official directly involved with the issuance of New

CREBs. The provision authorizes the Secretary to impose additional financial reporting requirements by regulation.[15]

Effective Date

The provision is effective for bonds issued after the date of enactment.

6. Expansion and modification of the advanced coal project credit (sec. 1507 of the bill and sec. 48A of the Code)

Present Law

An investment tax credit is available for power generation projects that use integrated gasification combined cycle ("IGCC") or other advanced coal-based electricity generation technologies. The credit amount is 20 percent for investments in qualifying IGCC projects and 15 percent for investments in qualifying projects that use other advanced coal-based electricity generation technologies.

To qualify, an advanced coal project must be located in the United States and use an advanced coal-based generation technology to power a new electric generation unit or to retrofit or repower an existing unit. Generally, an electric generation unit using an advanced coal-based technology must be designed to achieve a 99 percent reduction in sulfur dioxide and a 90 percent reduction in mercury, as well as to limit emissions of nitrous oxide and particulate matter.[16]

The fuel input for a qualifying project, when completed, must use at least 75 percent coal. The project, consisting of one or more electric generation units at one site, must have a nameplate generating capacity of at least 400 megawatts, and the taxpayer must provide evidence that a majority of the output of the project is reasonably expected to be acquired or utilized.

Credits are available only for projects certified by the Secretary of Treasury, in consultation with the Secretary of Energy. Certifications are issued using a competitive bidding process. The Secretary of Treasury must establish a certification program no later than 180 days after August 8, 2005,[17] and each project application must be submitted during the three-year period beginning on the date such certification program is established. An applicant for certification has two years from the date the Secretary accepts the application to provide the

---

[15] A technical correction may be necessary to clarify the application of this requirement to New CREBs.

[16] For advanced coal project certification applications submitted after October 2, 2006, an electric generation unit using advanced coal-based generation technology designed to use subbituminous coal can meet the performance requirement relating to the removal of sulfur dioxide if it is designed either to remove 99 percent of the sulfur dioxide or to achieve an emission limit of 0.04 pounds of sulfur dioxide per million British thermal units on a 30-day average.

[17] The Secretary issued guidance establishing the certification program on February 21, 2006 (IRS Notice 2006-24).

Secretary with evidence that the requirements for certification have been met. Upon certification, the applicant has five years from the date of issuance of the certification to place the project in service.

The Secretary of Treasury may allocate $800 million of credits to IGCC projects and $500 million to projects using other advanced coal-based electricity generation technologies. Qualified projects must be economically feasible and use the appropriate clean coal technologies. With respect to IGCC projects, credit-eligible investments include only investments in property associated with the gasification of coal, including any coal handling and gas separation equipment. Thus, investments in equipment that could operate by drawing fuel directly from a natural gas pipeline do not qualify for the credit.

In determining which projects to certify that use IGCC technology, the Secretary must allocate power generation capacity in relatively equal amounts to projects that use bituminous coal, subbituminous coal, and lignite as primary feedstock. In addition, the Secretary must give high priority to projects which include greenhouse gas capture capability, increased by-product utilization, and other benefits.

Explanation of Provision

The provision increases to 30 percent the credit rate for IGCC and other advanced coal projects. In addition, the provision permits the Secretary to allocate an additional $1 billion of credits to qualifying IGCC projects and $500 million of credits to qualifying projects using other advanced coal-based electricity generation technologies.

The provision modifies the definition of qualifying projects to require that projects include equipment which separates and sequesters at least 65 percent of the project's total carbon dioxide emissions. This percentage increases to 70 percent if the credits are later reallocated by the Secretary. The Secretary is required to recapture the benefit of any allocated credit if a project fails to attain or maintain these carbon dioxide separation and sequestration requirements.

In selecting projects, the provision requires the Secretary to give high priority to applicants who have a research partnership with an eligible educational institution. In addition, the Secretary must give the highest priority to projects with the greatest separation and sequestration percentage of total carbon dioxide emissions.

In implementing either section 48A (relating to the credit described above) or section 48B (relating to the coal gasification credit), the provision directs the Secretary to modify the terms of any competitive certification award and any associated closing agreements in certain cases. Specifically, modification is required when it (1) is consistent with the objectives of such section, (2) is requested by the recipient of the award, and (3) involves moving the project site to improve the potential to capture and sequester carbon dioxide emissions, reduce costs of transporting feedstock, and serve a broader customer base. However, no modification is required if the Secretary determines that the dollar amount of tax credits available to the taxpayer under the applicable section would increase as a result of the modification or such modification would result in such project not being originally certified. In considering any such modification, the

Secretary must consult with other relevant Federal agencies, including the Department of Energy.

Effective Date

The provision authorizing the Secretary to allocate additional credits is effective on the date of enactment. The increased credit rate along with the carbon dioxide sequestration and other rules (other than the term modification provision) are effective with respect to these additional credit allocations. The provision directing the Secretary to modify the terms of certain competitive certification awards and associated closing agreements is effective for awards issued before, on, or after the date of enactment.

7. Expansion and modification of the coal gasification project credit (sec. 1508 of the bill and sec. 48B of the Code)

Present Law

A 20 percent investment tax credit is available for investments in certain qualifying coal gasification projects. Only property which is part of a qualifying gasification project and necessary for the gasification technology of such project is eligible for the gasification credit.

Qualified gasification projects convert coal, petroleum residue, biomass, or other materials recovered for their energy or feedstock value into a synthesis gas composed primarily of carbon monoxide and hydrogen for direct use or subsequent chemical or physical conversion. Qualified projects must be carried out by an eligible entity, defined as any person whose application for certification is principally intended for use in a domestic project which employs domestic gasification applications related to (1) chemicals, (2) fertilizers, (3) glass, (4) steel, (5) petroleum residues, (6) forest products, and (7) agriculture, including feedlots and dairy operations.

Credits are available only for projects certified by the Secretary of Treasury, in consultation with the Secretary of Energy. Certifications are issued using a competitive bidding process. The Secretary of Treasury must establish a certification program no later than 180 days after August 8, 2005,[18] and each project application must be submitted during the 3-year period beginning on the date such certification program is established. The Secretary of Treasury may not allocate more than $350 million in credits. In addition, the Secretary may certify a maximum of $650 million in qualified investment as eligible for credit with respect to any single project.

Explanation of Provision

The provision increases to 30 percent the credit rate for the coal gasification investment credit. The provision also permits the Secretary to allocate an additional $500 million of credits to qualifying coal gasification projects. The provision requires that this additional amount be

[18] The Secretary issued guidance establishing the certification program on February 21, 2006 (IRS Notice 2006-25).

allocated to qualifying gasification projects that include equipment which separates and sequesters at least 75 percent of such project's total carbon dioxide emissions. The Secretary is required to recapture the benefit of any allocated credit if a project fails to attain or maintain the carbon dioxide separation and sequestration requirements.

In selecting projects, the provision requires the Secretary to give high priority to applicants who have a research partnership with an eligible educational institution. In addition, the Secretary must give the highest priority to projects with the greatest separation and sequestration percentage of total carbon dioxide emissions.

Effective Date

The provision authorizing the Secretary to allocate additional credits is effective on date of enactment. The increased credit rate along with the carbon dioxide sequestration and other rules are effective with respect to these additional credit allocations.

8. Seven-year applicable recovery period for depreciation of qualified carbon dioxide pipeline property (sec. 1509 of the bill and sec. 168(e) 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.[19] The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[20] Assets included in class 46.0, describing assets used in the private, commercial, and contract carrying of petroleum, gas and other products by means of pipes and conveyors, are assigned a class life of 22 years and a recovery period of 15 years.

Explanation of Provision

The provision provides a seven-year recovery period for qualified carbon dioxide pipeline property placed in service before January 1, 2011. For purposes of the provision, the term qualified carbon dioxide pipeline means property, the original use of which commences with the taxpayer and the original purposes of which is to transport qualified carbon dioxide, used in the United States solely to transmit qualified carbon dioxide from the point of capture to a secure geological storage or the point at which such qualified carbon dioxide is used as a tertiary injectant.[21]

---

[19] Sec. 168.

[20] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

[21] Tertiary injectant has the same meaning as when used within section 193(b)(1).

Qualified carbon dioxide is defined under the provision as carbon dioxide captured from an industrial source that would otherwise be released into the atmosphere as an industrial emission of greenhouse gas and is measured at the source of capture and verified at the point of disposal or injection.

Secure geological storage shall be defined in regulations by the Secretary, in consultation with the Administrator of the Environmental Protection Agency, for determining adequate security measures for the geological storage of carbon dioxide, such that the carbon dioxide does not escape into the atmosphere. Such term shall include storage at deep saline formations and unminable coal seams under such conditions as the Secretary may determine under such regulations.

Effective Date

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

9. Temporary procedures for excise tax refunds on exported coal (sec. 1510 of the bill)

Present Law

In general

Excise tax is imposed on coal, except lignite, produced from mines located in the United States.[22] The producer of the coal is liable for paying the tax to the IRS. Producers generally recover the tax from their purchasers.

The Export Clause of the U.S. Constitution provides that "no Tax or Duty shall be laid on Articles exported from any State."[23] Courts have determined that the Export Clause applies to excise tax on exported coal, and therefore such taxes are subject to a claim for refund.[24] The courts have further determined that there are two procedural means to judicially obtain such refunds, under the Code or the Tucker Act.

Claims under the Code

Unless a claimant proceeds under the Tucker Act, claims by coal producers and exporters for refunds or credits of excise taxes on exported coal are governed by the general Code rules for

---

[22] Sec. 4121(a). Throughout the relevant period, the rate of tax on coal from underground mines has been $1.10 per ton and the rate of tax on coal from surface mines has been $0.55 per ton. These rates are subject to a limitation of 4.4 percent of the producer's sale price. Sec. 4121(b).

[23] U.S. Const., art. I, sec. 9, cl. 5.

[24] See *Ranger Fuel Corp. v. United States*, 33 F. Supp. 2d 466 (E.D. Va. 1998). The IRS subsequently provided guidance regarding how taxpayers may assure that exported coal would not be subject to excise tax. Notice 2000-28, 2000-1 C.B. 1116.

refunds of tax on exported items. A claimant must satisfy the following requirements of the Code and case law:

1. A claim for refund must be filed within three years from the time the return was filed, or within two years from the time the tax was paid, whichever period expires later;[25]

2. The person must establish that the goods were in the stream of export when the excise tax was imposed;[26]

3. The claimant must establish that it has borne the tax. More specifically, the claimant must establish that the tax was neither included in the price of the article nor collected from the purchaser (or if so, that the claimant has repaid the amount of tax to the ultimate purchaser), that the claimant has repaid or agreed to repay the tax to the ultimate vendor or has obtained the written consent of such ultimate vendor to the allowance of the claim, or that the claimant has filed the written consent of the ultimate purchaser to the allowance of the claim;[27]

4. In the case of an exporter or shipper of an article exported to a foreign country or shipped to a possession, the amount of tax may be refunded to the exporter or shipper if the person who paid the tax waives its claim to such amount;[28] and

5. A civil action for refund must not be begun before the expiration of six months from the date of filing the claim (unless the claim has been disallowed during that time), nor after the expiration of two years from the date of mailing the notice of claim disallowance.[29]

In 2000, the Internal Revenue Service ("IRS") issued Notice 2000-28,[30] which summarizes the IRS position regarding claims for credits or refunds of excise taxes on exported coal and sets forth procedural rules relating to such claims. Under Notice 2000-28, a coal producer or exporter must provide the following information as part of its claim:

---

[25] Sec. 6511(a).

[26] See *Ranger Fuel Corp. v. United States*, 33 F. Supp. 2d 466 (E.D. Va. 1998). See also *United States v. International Business Machines Corp.*, 517 U.S. 843 (1996); *Joy Oil, Ltd. v. State Tax Commission*, 337 U.S. 286 (1949).

[27] Sec. 6416(a)(1).

[28] Sec. 6416(c).

[29] Sec. 6532(a).

[30] Notice 2000-28, 2001-1 C.B. 1116.

1. A statement by the person that paid the tax to the government that provides the quarter and the year for which the tax was reported on Form 720, the line number on such Form, the amount of tax paid on the coal, and the date of payment;

2. In the case of an exporter, a statement by the person that paid the tax to the government that such person has waived the right to claim a refund;

3. A statement that the claimant has evidence that the coal was in the stream of export when sold by the producer;

4. In the case of an exporter, proof of exportation;

5. In the case of a coal producer, a statement that the coal actually was exported; and

6. A statement that the claimant:

   a. has neither included the tax in the price of the coal nor collected the amount of the tax from its buyer,

   b. has repaid the amount of the tax to the ultimate purchaser of the coal, or

   c. has obtained the written consent of the ultimate purchaser of the coal to the allowance of the claim.

If the IRS disallows the claim, the claimant may proceed in a Federal district court or the Court of Federal Claims under 28 U.S.C. sec. 1346(a)(1), which affords the Federal district courts concurrent jurisdiction with the Court of Federal Claims over "[a]ny civil action against the United States for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected … or any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws."

With respect to claims under the Code allowed by the IRS or by a court, prejudgment interest is generally allowed.[31]

Claims under the Tucker Act

Instead of proceeding under the Code, a person may claim a refund in the Court of Federal Claims under the Export Clause and the Tucker Act, which confers jurisdiction upon such court "to render judgment upon any claim against the United States founded either upon the Constitution, or any Act of Congress or any regulation of an executive department …."[32] A claim for such a refund under the Tucker Act is not bound by the Code requirements described above (it is bound by the case law requirement that the claimant must establish that the goods were in the stream of export when the excise tax was imposed) and is entitled to the benefit of a

---

[31] See sec. 6611; 28 U.S.C. sec. 2411.

[32] 28 U.S.C. sec. 1491(a).

six-year statute of limitations.[33] The Court of Appeals for the Federal Circuit held that such claims accrue prejudgment interest, reversing the Court of Federal Claims on that issue; however, the Supreme Court has granted certiorari in that case.[34] In addition, the claimant in such a proceeding is subject to general rules of judicial standing, which may bar certain exporters from prevailing in such a proceeding.[35]

Explanation of Provision

The provision creates a new procedure under which certain coal producers and exporters may claim a refund of excise taxes imposed on coal exported from the United States. Coal producers or exporters that exported coal during the period beginning on or after October 1, 1990 and ending on or before the date of enactment of the provision, with respect to which a return was filed on or after October 1, 1990, and on or before the date of enactment, and that file a claim for refund not later than the close of the 30-day period beginning on the day of enactment, may obtain a refund from the Secretary of the Treasury of excise taxes paid on such exported coal and any interest accrued from the date of overpayment. Interest on such claims is computed under the Code.[36] The Secretary of the Treasury is required to determine whether to approve the claim within 180 days after such claim is filed, and to pay such claim not later than 180 days after making such determination.

In order to qualify for a refund under the provision, a coal producer must establish that it, or a party related to such coal producer, exported coal produced by such coal producer to a foreign country or shipped coal produced by such coal producer to a U.S. possession, the export or shipment of which was other than through an exporter that has filed a valid and timely claim for refund under the provision. An exporter must establish that it exported coal to a foreign country, shipped coal to a U.S. possession, or caused such coal to be so exported or shipped. Refunds to producers are to be made in an amount equal to the tax paid on exported coal. Exporters are to receive a payment equal to $0.825 per ton of exported coal.

Special rules apply if a court has rendered a judgment. If a coal producer or a party related to a coal producer has received, from a court of competent jurisdiction in the United States, a judgment in favor of such coal producer (or party related to such coal producer) that relates to the constitutionality of Federal excise tax paid on exported coal, then such coal

---

[33] *Venture Coal Sales Co. v. U.S.*, 93 AFTR 2d 2004-2495 (Fed. Cir. 2004); *Cyprus Amax Coal Co. v. U.S.*, 205 F.3d 1369 (Fed. Cir. 2000).

[34] *Clintwood Elkhorn Mining Company, v. U.S.*, 473 F.3d 1373 (Fed. Cir. 2007), *rev'g sub. nom. Andelex Resources, Inc. v. U.S.*, No. 00-cv-249 (Fed. Cl. July 21, 2004), *cert granted,* No. 07-308 (Dec. 3, 2007).

[35] See, e.g., *Emerald Int'l Corp. v. U.S.*, 90 AFTR 2d 2002-7710 (Ct. Fed. Cl. 2002) (exporter lacked standing because tax was imposed upon the producer, which had no obligation to pass on the tax to exporter).

[36] See sec. 6621.

producer is deemed to have established the export of coal to a foreign country or shipment of coal to a possession of the United States. If such coal producer is entitled to a payment under this provision, the amount of such payment is reduced by any amount awarded under such court judgment. In the event such judgment is later overturned, the coal producer must pay to the Secretary the amount of any payment received under the provision unless the coal producer establishes the export of the coal to a foreign country or shipment of coal to a possession of the United States. Subject to the rules below, a coal exporter may file a claim notwithstanding that a coal producer or a party related to a coal producer has received a court judgment relating to the same coal.

Under the provision, the term "coal producer" means the person that owns the coal immediately after the coal is severed from the ground, without regard to the existence of any contractual arrangement for the sale or other disposition of the coal or the payment of any royalties between the producer and third parties. The term also includes any person who extracts coal from coal waste refuse piles or from the silt waste product which results from the wet washing or similar processing of coal. The term "exporter" means a person, other than a coal producer, that does not have an agreement with a producer or seller of such coal to sell or export such coal to a third party on behalf of such producer or seller, and that is indicated as the exporter of record in the shipper's export declaration or other documentation, or actually exported such coal to a foreign country, shipped such coal to a U.S. possession, or caused such coal to be so exported or shipped. The term "a party related to such coal producer" means a person that is related to such coal producer through any degree of common management, stock ownership, or voting control, is related, within the meaning of section 144(a)(3), to such coal producer, or has a contract, fee arrangement, or any other agreement with such coal producer to sell such coal to a third party on behalf of such coal producer.

The provision does not apply with respect to excise tax on exported coal if a credit or refund of such tax has been allowed or made, or if a "settlement with the Federal Government" has been made with and accepted by the coal producer, a party related to such coal producer, or the exporter of such coal, as of the date that the claim is filed under the provision. The term "settlement with the Federal Government" does not include a settlement or stipulation entered into as of the date of enactment, if such settlement or stipulation contemplates a judgment with respect to which any party has filed an appeal or has reserved the right to file an appeal. In addition, the provision does not apply to the extent that a credit or refund of tax on exported coal has been paid to any person, regardless of whether such credit or refund occurs prior to, or after, the date of enactment.

The provision does not confer standing upon an exporter to commence, or intervene in, any judicial or administrative proceeding concerning a claim for refund by a coal producer of any Federal or State tax, fee, or royalty paid by the coal producer. The provision does not confer standing upon a coal producer to commence, or intervene in, any judicial or administrative proceeding concerning a claim for refund by an exporter of any Federal or State tax, fee, or royalty paid by the producer and alleged to have been passed on to an exporter.

Effective Date

The provision applies to claims on coal exported on or after October 1, 1990 through the date of enactment, with respect to amounts of tax for which a return was filed on or after October 1, 1990, and on or before the date of enactment, and for which a claim for refund is filed not later than the close of the 30-day period beginning on the date of enactment.

10. Extend excise tax on coal at current rates (sec. 1511 of the bill and sec. 4121 of the Code)

Present Law

A $1.10 per ton excise tax is imposed on coal sold by the producer from underground mines in the United States. The rate is 55 cents per ton on coal sold by the producer from surface mining operations. In either case, the tax cannot exceed 4.4 percent of the coal producer's selling price. No tax is imposed on lignite.

Gross receipts from the excise tax are dedicated to the Black Lung Disability Trust Fund to finance benefits under the Federal Black Lung Benefits Act. Currently, the Black Lung Disability Trust Fund is in a deficit position because previous spending was financed with interest-bearing advances from the General Fund.

The coal excise tax rates are scheduled to decline to 50 cents per ton for underground-mined coal and 25 cents per ton for surface-mined coal (and the cap is scheduled to decline to two percent of the selling price) for sales after January 1, 2014, or after any earlier January 1 on which there is no balance of repayable advances from the Black Lung Disability Trust Fund to the General Fund and no unpaid interest on such advances.

Explanation of Provision

The provision retains the excise tax on coal at the current rates until the earlier of the following dates: (1) January 1, 2018, and (2) the day after the first December 31 after 2007 on which the Black Lung Disability Trust Fund has repaid, with interest, all amounts borrowed from the General Fund. On and after that date, the reduced rates of $.50 per ton for coal from underground mines and $.25 per ton for coal from surface mines will apply and the tax per ton of coal will be capped at two percent of the amount for which it is sold by the producer.

Effective Date

The provision is effective on the date of enactment.

11. Carbon audit of the tax code (sec. 1512 of the bill)

Present Law

Present law does not require a review of the Code for provisions that affect carbon emissions and climate. The National Research Council is part of the National Academies. The National Academy of Sciences serves to investigate, examine, experiment, and report upon any subject of science whenever called upon to do so by any department of the government. The National Research Council was organized by the National Academy of Sciences in 1916 and is its principal operating agency for conducting science policy and technical work.

Explanation of Provision

The provision directs the Secretary to request that the National Academy of Sciences undertake a comprehensive review of the Code to identify the types of and specific tax provisions that have the largest effects on carbon and other greenhouse gas emissions and to generally estimate the magnitude of those effects.[37] The report should identify the provisions of the Code that are most likely to have significant effects on carbon emissions and discuss the importance of controlling carbon and greenhouse gas emissions as part of a comprehensive national strategy for reducing U.S. contributions to global climate change.[38] The report will describe the processes by which the tax provisions affect emissions (both directly and indirectly), assess the relative influence of the identified provisions, and evaluate the potential for changes in the Code to reduce carbon emissions. The report also will identify other provisions of the Code that may have significant influence on other factors affecting climate change.

The Secretary is to submit to Congress a report containing the results of the National Academy of Sciences review within two years of the date of enactment. The provision authorizes the appropriation of $1,500,000 to carry out the review.

Effective Date

The provision is effective on the date of enactment.

---

[37] A detailed quantitative analysis is not required. It is envisioned that the review will catalogue and provide a general analysis of the effect of each identified provision.

[38] “Greenhouse gas emissions” include, but are not limited to, methane, nitrous oxide, ozone, and fluorinated hydrocarbons.

B. Transportation and Domestic Fuel Security Provisions

1. Credit for production of cellulosic biomass alcohol (sec. 1521 of the bill and sec. 40 of the Code)

Present Law

The alcohol fuels credit is the sum of three credits: the alcohol mixture credit, the alcohol credit, and the small ethanol producer credit. Generally, the alcohol fuels credit expires after December 31, 2010.[39]

Taxpayers are eligible for an income tax credit of 51 cents per gallon of ethanol (60 cents in the case of alcohol other than ethanol) used in the production of a qualified mixture (the "alcohol mixture credit"). A "qualified mixture" means a mixture of alcohol and gasoline, (or of alcohol and a special fuel) sold by the taxpayer as fuel, or used as fuel by the taxpayer producing such mixture. The term "alcohol" includes methanol and ethanol but does not include (1) alcohol produced from petroleum, natural gas, or coal (including peat), or (2) alcohol with a proof of less than 150.

Taxpayers may reduce their income taxes by 51 cents for each gallon of ethanol, which is not in a mixture with gasoline or other special fuel, that they sell at the retail level as vehicle fuel or use themselves as a fuel in their trade or business ("the alcohol credit"). For alcohol other than ethanol, the rate is 60 cents per gallon.[40]

In the case of ethanol, the Code provides an additional 10-cents-per-gallon credit for up to 15 million gallons per year for small producers. Small producer is defined generally as persons whose production capacity does not exceed 60 million gallons per year. The ethanol must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified alcohol fuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such ethanol at retail to another person and places such ethanol in the fuel tank of such other person; or (2) used by the producer for any purpose described in (1)(a), (b), or (c). A cooperative may pass through the small ethanol producer credit to its patrons.

Explanation of Provision

The provision adds a fourth component to the alcohol fuels credit. The provision provides a per gallon income tax credit for up to 60 million gallons of qualified cellulosic biomass alcohol fuel production of the producer for the taxable year. The credit is $1.01 less the

---

[39] The alcohol fuels credit is unavailable when, for any period before January 1, 2011, the tax rates for gasoline and diesel fuels drop to 4.3 cents per gallon.

[40] In the case of any alcohol (other than ethanol) with a proof that is at least 150 but less than 190, the credit is 45 cents per gallon (the "low-proof blender amount"). For ethanol with a proof that is at least 150 but less than 190, the low-proof blender amount is 37.78 cents.

amount of the alcohol mixture credit in effect at the time of the qualified cellulosic alcohol production. For example, on January 1, 2008, the applicable amount of the credit is 50 cents [$1.01 - $0.51 = $0.50]. It is irrelevant whether the producer actually claims the alcohol mixture credit. If the alcohol mixture credit expires as scheduled, the cellulosic alcohol producer credit would be $1.01 beginning January 1, 2011.

Qualified cellulosic alcohol production is any cellulosic biomass alcohol that is produced by the taxpayer and during the taxable year is (1) sold by the taxpayer to another person (a) for use by such other person in the production of a qualified alcohol fuel mixture in such other person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such cellulosic biomass alcohol at retail to another person and places such alcohol in the fuel tank of such other person; or (2) is used by the producer for any purpose described in (1)(a), (b), or (c). Qualified cellulosic alcohol production does not include any alcohol that is purchased by the taxpayer with respect to which the taxpayer increases the proof through further distillation.

Cellulosic biomass alcohol is alcohol that (1) is produced in the United States, (2) is derived from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis, and (3) has a proof of 150 or greater. A person claiming the cellulosic alcohol producer credit cannot also claim the small ethanol producer credit. A cooperative may pass through the cellulosic alcohol producer credit to its patrons.

The cellulosic alcohol producer credit is available with respect to qualified cellulosic alcohol production after December 31, 2007, and before January 1, 2014.

Effective Date

The provision is effective for alcohol produced after December 31, 2007.

2. Expansion of special depreciation allowance for cellulosic biomass ethanol plant property (sec. 1522 of the bill and sec. 168(l) of the Code)

Present Law

Section 168(l) allows an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified cellulosic biomass ethanol plant property. In order to qualify, the property generally must be placed in service before January 1, 2013.

Qualified cellulosic biomass ethanol plant property means property used in the U.S. solely to produce cellulosic biomass ethanol. For this purpose, cellulosic biomass ethanol means ethanol derived from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis. For example, lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis includes bagasse (from sugar cane), corn stalks, and switchgrass.

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, 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 the following requirements. The original use of the property must commence with the taxpayer on or after December 20, 2006. The property must be acquired by purchase (as defined under section 179(d)) by the taxpayer after December 20, 2006, and placed in service before January 1, 2013. Property does not qualify if a binding written contract for the acquisition of such property was in effect on or before December 20, 2006.

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 after December 20, 2006, and the property is placed in service before January 1, 2013 (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.

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 if the property ceases to be qualified cellulosic biomass ethanol plant property.

Property with respect to which the taxpayer has elected 50 percent expensing under section 179C is not eligible for the additional first-year depreciation deduction.

Explanation of Provision

The provision changes the definition of qualified property. Under the provision, qualified property includes cellulosic biomass alcohol, which is defined as any alcohol produced from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis.

Effective Date

The provision is effective for property placed in service after the date of enactment in taxable years ending after such date.

3. Modification of alcohol credits (sec. 1523 of the bill and secs. 40, 6426 and 6427 of the Code)

Present Law

Income tax credit

The alcohol fuels credit is the sum of three credits: the alcohol mixture credit, the alcohol credit, and the small ethanol producer credit. Generally, the alcohol fuels credit expires after December 31, 2010.

Taxpayers are eligible for an income tax credit of 51 cents per gallon of ethanol (60 cents in the case of alcohol other than ethanol) used in the production of a qualified mixture (the "alcohol mixture credit"). A "qualified mixture" means a mixture of alcohol and gasoline, (or of alcohol and a special fuel) sold by the taxpayer as fuel, or used as fuel by the taxpayer producing such mixture. The term "alcohol" includes methanol and ethanol but does not include (1) alcohol produced from petroleum, natural gas, or coal (including peat), or (2) alcohol with a proof of less than 150.

Taxpayers may reduce their income taxes by 51 cents for each gallon of ethanol, which is not in a mixture with gasoline or other special fuel, that they sell at the retail level as vehicle fuel or use themselves as a fuel in their trade or business ("the alcohol credit"). For alcohol other than ethanol, the rate is 60 cents per gallon.

In the case of ethanol, the Code provides an additional 10-cents-per-gallon credit for up to 15 million gallons per year for small producers. Small producer is defined generally as persons whose production capacity does not exceed 60 million gallons per year. The ethanol must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified alcohol fuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such ethanol at retail to another person and places such ethanol in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c). A cooperative may pass through the small ethanol producer credit to its patrons.

Excise tax credit and payment provision for alcohol fuel mixtures

The Code also provides an excise tax credit and payment provision for alcohol fuel mixtures. Like the income tax credit, the amount of the credit is 60 cents per gallon of alcohol used as part of a qualified mixture (51 cents in the case of ethanol). For purposes of the excise tax credit and payment provisions, alcohol includes methanol and ethanol but does not include (1) alcohol produced from petroleum, natural gas, or coal (including peat), or (2) alcohol with a proof of less than 190. Such term also includes an alcohol gallon equivalent of ethyl tertiary butyl either or other ethers produced from alcohol. In lieu of a tax credit, a person making a qualified mixture eligible for the credit may seek a payment from the Secretary in the amount of the credit. The payment provisions and credits are coordinated such that the incentive is not claimed more than once for each gallon of alcohol used as part of qualified mixture.

Renewable Fuels Standard Program

Under the Renewable Fuels Standard Program all renewable fuel produced or imported on or after September 1, 2007 must have a renewable identification number (RIN) associated with it. Producers and importers must generate RINs to represent all the renewable fuel they produce or import and provide those RINs to the Environmental Protection Agency. For cellulosic ethanol, 2.5 RINs are generated for every gallon produced.

Explanation of Provision

Under the provision, the 51-cent-per-gallon incentive for ethanol is adjusted to 46 cents per gallon beginning with the first calendar year after 7.5 billion gallons of ethanol (including cellulosic ethanol) has been produced or imported into the United States during any calendar year beginning after 2007, as certified by the Secretary, in consultation with the Administrator of the Environmental Protection Agency.

Effective Date

The provision is effective on the date of enactment.

4. Extension and modification of credits for biodiesel and renewable diesel (sec. 1524 of the bill and secs. 40A, 6426, and 6427 of the Code)

Present Law

Income tax credit

Overview

The Code provides an income tax credit for biodiesel fuels (the "biodiesel fuels credit").[41] The biodiesel fuels credit is the sum of the biodiesel mixture credit, the biodiesel credit and the small agri-biodiesel producer credit. The biodiesel fuels credit is treated as a general business credit. The amount of the biodiesel fuels credit is includable in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions discussed below. The credit does not apply to fuel sold or used after December 31, 2008.

Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter that meet (1) the registration requirements established by the Environmental Protection Agency under section 211 of the Clean Air Act and (2) the requirements of the American Society of Testing and Materials ("ASTM") D6751. Agri-biodiesel is biodiesel derived solely from virgin oils including oils from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, or animal fats.

[41] Sec. 40A.

Biodiesel may be taken into account for purposes of the credit only if the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer or importer of the biodiesel which identifies the product produced and the percentage of the biodiesel and agri-biodiesel in the product.

Biodiesel mixture credit

The biodiesel mixture credit is 50 cents for each gallon of biodiesel (other than agri-biodiesel) used by the taxpayer in the production of a qualified biodiesel mixture. For agri-biodiesel, the credit is $1.00 per gallon. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that is (1) sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. The sale or use must be in the trade or business of the taxpayer and is to be taken into account for the taxable year in which such sale or use occurs. No credit is allowed with respect to any casual off-farm production of a qualified biodiesel mixture.

Biodiesel credit

The biodiesel credit is 50 cents for each gallon of biodiesel which is not in a mixture with diesel fuel (100 percent biodiesel or B-100) and which during the taxable year is (1) used by the taxpayer as a fuel in a trade or business or (2) sold by the taxpayer at retail to a person and placed in the fuel tank of such person's vehicle. For agri-biodiesel, the credit is $1.00 per gallon.

Small agri-biodiesel producer credit

The Code provides a small agri-biodiesel producer income tax credit, in addition to the biodiesel and biodiesel fuel mixture credits. The credit is a 10-cents-per-gallon credit for up to 15 million gallons of agri-biodiesel produced by small producers, defined generally as persons whose agri-biodiesel production capacity does not exceed 60 million gallons per year. The agri-biodiesel must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified biodiesel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such agri-biodiesel at retail to another person and places such ethanol in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c).

Biodiesel mixture excise tax credit

The Code also provides an excise tax credit for biodiesel mixtures.[42] The credit is 50 cents for each gallon of biodiesel used by the taxpayer in producing a biodiesel mixture for sale or use in a trade or business of the taxpayer. In the case of agri-biodiesel, the credit is $1.00 per gallon. A biodiesel mixture is a mixture of biodiesel and diesel fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. No credit is allowed unless the taxpayer obtains a certification

[42] Sec. 6426(c).

(in such form and manner as prescribed by the Secretary) from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.[43]

The credit is not available for any sale or use for any period after December 31, 2008. This excise tax credit is coordinated with the income tax credit for biodiesel such that credit for the same biodiesel cannot be claimed for both income and excise tax purposes.

Payments with respect to biodiesel fuel mixtures

If any person produces a biodiesel fuel mixture in such person's trade or business, the Secretary is to pay such person an amount equal to the biodiesel mixture credit.[44] The payment provision does not apply to biodiesel fuel mixtures sold or used after December 31, 2008.

Renewable diesel

"Renewable diesel" is diesel fuel that (1) is derived from biomass (as defined in section 45K(c)(3)) using a thermal depolymerization process; (2) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency ("EPA") under section 211 of the Clean Air Act (42 U.S.C. sec. 7545); and (3) meets the requirements of the ASTM D975 or D396. ASTM D975 provides standards for diesel fuel suitable for use in diesel engines. ASTM D396 provides standards for fuel oil intended for use in fuel-oil burning equipment, such as furnaces.

For purposes of the Code, renewable diesel is generally treated the same as biodiesel. Like biodiesel, the incentive may be taken as an income tax credit, an excise tax credit, or as a payment from the Secretary.[45] The incentive for renewable diesel is $1.00 per gallon and there is no small producer credit for renewable diesel. The incentives for renewable diesel expire after December 31, 2008.

Explanation of Provision

The provision extends an additional two years (through December 31, 2010) the income tax credit, excise tax credit, and payment provisions for biodiesel (including agri-biodiesel) and renewable diesel.

The provision modifies the definition of renewable diesel to eliminate the requirement that the fuel be made using a thermal depolymerization process.[46] The provision also requires

---

[43] Sec. 6426(c)(4).

[44] Sec. 6427(e).

[45] Secs. 40A(f), 6426(c), and 6427(e).

[46] Section 1525 of the bill, discussed *infra*, excludes from the definition of renewable diesel biomass fuel co-produced with petroleum or other feedstocks that are not biomass.

that all renewable diesel meet the ASTM D975 standard by eliminating the ASTM D396 standard from the definition of renewable diesel. The provision permits the Secretary to identify standards equivalent to ASTM D975 for renewable diesel suitable for use in diesel-powered highway vehicles.

The provision also provides that renewable diesel includes biomass fuel that meets a Department of Defense military specification for jet fuel or an ASTM for aviation turbine fuel.

Effective Date

The provision is generally effective for fuel produced, and sold or used, after the date of enactment. The elimination of the ASTM D396 standard and the elimination of the requirement that the fuel be made through a thermal depolymerization process is effective for fuel produced, and sold or used, after the date that is 30 days after the date of enactment.

5. Clarification of eligibility for renewable diesel credit (sec. 1525 of the bill and secs. 40A and 6426 of the Code)

Present Law

Renewable diesel

The Code provides a tax incentive of $1.00 per gallon for renewable diesel. This incentive may be taken as an income tax credit, an excise tax credit, or as a payment from the Secretary.[47] "Renewable diesel" means diesel fuel that (1) is derived from biomass (as defined in section 45K(c)(3)) using a thermal depolymerization process; (2) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency under section 211 of the Clean Air Act (42 U.S.C. sec. 7545); and (3) meets the requirements of the American Society of Testing and Materials ("ASTM") D975 or D396. ASTM D975 provides standards for diesel fuel suitable for use in diesel engines. ASTM D396 provides standards for fuel oil intended for use in fuel-oil burning equipment, such as furnaces. Biomass, as defined in section 45K(c)(3), is any organic material other than (1) oil and natural gas (or any product thereof), and (2) coal (including lignite) or any product thereof.

Pursuant to IRS Notice 2007-37, the Secretary provided that fuel produced as a result of co-processing biomass and petroleum feedstock ("co-produced fuel") qualifies for the renewable diesel incentives to the extent of the fuel attributable to the biomass in the mixture. In co-produced fuel, the fuel attributable to the biomass does not exist as a distinct separate quantity prior to mixing.

---

[47] Secs. 40A, 6426(c), and 6427(e). For purposes of the Code, renewable diesel is generally treated as biodiesel.

Liquid hydrocarbons from biomass

The Code provides an excise tax credit 50 cents per gallon for certain alternative fuels.[48] Included among the qualified alternative fuels is a provision for liquid hydrocarbons produced from biomass. The Code does not define "liquid hydrocarbons." However, fuel that is ethanol, methanol, biodiesel, or renewable diesel does not qualify as an alternative fuel.

On December 3, 2007, the IRS issued Notice 2007-97 concerning the definition of liquid hydrocarbon. The notice indicated that the Treasury and the IRS has received numerous inquiries as to whether the term "liquid hydrocarbon from biomass" can include liquids that contain oxygen as well as carbon. The notice observed that the Senate Finance Committee had approved a technical correction that would clarify that liquid fuel derived from biomass qualifies as an alternative fuel. Notice 2007-49 defines "liquid hydrocarbon from biomass" as chemical compounds that are liquid when eligibility for the credit or payment is determined and are derived from any organic material, including oceanic and terrestrial crops and crop residues, and organic waste products have market value.

Explanation of Provision

The provision overrides IRS Notice 2007-37 with respect to co-produced fuel, providing that renewable diesel does not include any fuel derived from co-processing biomass with a feedstock that is not biomass. The de minimis use of catalysts, such as hydrogen, is permitted under the provision.

Consistent with IRS Notice 2007-49, the provision also clarifies the alternative fuel credit by replacing the term "liquid hydrocarbons" with "liquid fuel." The provision also provides that alcohol, biodiesel, renewable diesel, and qualified mixtures thereof (as subsections (b) and (c) of section 6426 and sections 40 and 40A) do not qualify for the alternative fuel and alternative fuel mixture credit.

Effective Date

The provision is generally effective for fuel produced and sold or used after December 31, 2007. The alternative fuel credit clarification is effective as if included in section 11113 of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users.

6. Provisions clarifying treatment of fuels with no nexus to the United States (sec. 1526 of the bill and secs. 40, 40A, 6426 and 6427 of the Code)

Present Law

The Code provides per-gallon incentives relating to the following qualified fuels: alcohol (including ethanol), biodiesel (including agri-biodiesel), renewable diesel, and certain alternative

[48] Sec. 6426(d). This incentive also can be taken as a payment under section 6427(e).

fuels.[49] The incentives may be taken as an income tax credit, excise tax credit or payment. The provisions are coordinated so that a gallon of qualified fuel is only taken into account once. If the qualified fuel is part of a qualified fuel mixture, the incentives apply only to the amount of qualified fuel in the mixture.

For alcohol, other than ethanol, the amount of the credit is 60 cents per gallon. For ethanol, the credit is 51 cents per gallon. The alcohol incentives expire after December 31, 2010. The amount of the credit for biodiesel is 50 cents. For agri-biodiesel and renewable diesel, the credit amount is $1.00 per gallon. The biodiesel, agri-biodiesel and renewable diesel incentives expire after December 31, 2008. The credit amount for alternative fuels is 50 cents per gallon. The incentives for alternative fuels expire after September 30, 2009 (after September 30, 2014, in the case of liquefied hydrogen).

The Code is silent as to the geographic limitations on where the fuel must be produced, used, or sold. For imported ethanol, there is an offsetting tariff of 54 cents per gallon. This tariff expires January 1, 2009.

Explanation of Provision

The provision makes a technical correction to clarify that foreign-produced fuel that is used or sold for use outside of the United States is ineligible for the per-gallon tax incentives relating to alcohol, biodiesel, renewable diesel, and alternative fuel.

Effective Date

For foreign produced alcohol and biodiesel used outside of the United States, the provision is effective as if included in section 301 of the American Jobs Creation Act of 2004; for foreign produced renewable diesel used outside of the United States, the provision is effective as if included in section 1346(c) of the Energy Policy Act of 2005; and for foreign produced alternative fuel used outside of the United States, the provision is effective as if included in section 11113 of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users.

7. Comprehensive study of biofuels (sec. 1527 of the bill)

Present Law

The National Academy of Sciences serves to investigate, examine, experiment, and report upon any subject of science whenever called upon to do so by any department of the government. The National Research Council is part of the National Academies. The National Research Council was organized by the National Academy of Sciences in 1916 and is its principal operating agency for conducting science policy and technical work.

[49] See secs. 40, 40A, 6426, and 6427(e).

Explanation of Provision

The provision requires the Secretary, in consultation with the Department of Energy and the Department of Agriculture and the Environmental Protection Agency, to enter into an agreement with the National Academy of Sciences to produce an analysis of current scientific findings to determine:

- Current biofuels production, as well as projections for future production;
- The maximum amount of biofuels production capable on U.S. farmland;
- The domestic effects of a dramatic increase in biofuels production on, for example, (a) the price of fuel, (b) the price of land in rural and suburban communities, (c) crop acreage and other land use, (d) the environment, due to changes in crop acreage, fertilizer use, runoff, water use, emissions from vehicles utilizing biofuels, and other factors, (e) the price of feed, (f) the selling price of grain crops, (g) exports and imports of grains, (h) taxpayers, through cost or savings to commodity crop payments, and (i) the expansion of refinery capacity;
- The ability to convert corn ethanol plants for other uses, such as cellulosic ethanol or biodiesel;
- A comparative analysis of corn ethanol versus other biofuels and renewable energy sources, considering cost, energy output, and ease of implementation; and
- The need for additional scientific inquiry, and specific areas of interest for future research.

The National Academy of Sciences shall issue an initial report of its findings to the Congress not later than three months after the date of enactment, and a final report not later than six months after the date of enactment.

Effective Date

The provision is effective on the date of enactment.

8. Alternative motor vehicle credit and plug-in electric vehicle credit (sec. 1528 of the bill and section 30B and new sec. 30D of the Code)

Present Law

In general

A credit is available for each new qualified fuel cell vehicle, hybrid vehicle, advanced lean burn technology vehicle, and alternative fuel vehicle placed in service by the taxpayer during the taxable year.[50] In general, the credit amount varies depending upon the type of

[50] Sec. 30B.

technology used, the weight class of the vehicle, the amount by which the vehicle exceeds certain fuel economy standards, and, for some vehicles, the estimated lifetime fuel savings. The credit generally is available for vehicles purchased after 2005. The credit terminates after 2009, 2010, or 2014, depending on the type of vehicle.

In general, the credit is allowed to the vehicle owner, including the lessor of a vehicle subject to a lease. If the use of the vehicle is described in paragraphs (3) or (4) of section 50(b) (relating to use by tax-exempt organizations, governments, and foreign persons) and is not subject to a lease, the seller of the vehicle may claim the credit so long as the seller clearly discloses to the user in a document the amount that is allowable as a credit. A vehicle must be used predominantly in the United States to qualify for the credit.

Fuel cell vehicles

A qualified fuel cell vehicle is a motor vehicle that is propelled by power derived from one or more cells that convert chemical energy directly into electricity by combining oxygen with hydrogen fuel that is stored on board the vehicle and may or may not require reformation prior to use. A qualified fuel cell vehicle must be purchased before January 1, 2015. The amount of credit for the purchase of a fuel cell vehicle is determined by a base credit amount that depends upon the weight class of the vehicle and, in the case of automobiles or light trucks, an additional credit amount that depends upon the rated fuel economy of the vehicle compared to a base fuel economy. For these purposes the base fuel economy is the 2002 model year city fuel economy rating for vehicles of various weight classes.[51] Table 2, below, shows the base credit amounts.

Table 2.–Base Credit Amount for Fuel Cell Vehicles

Vehicle Gross Weight Rating (pounds)	Credit Amount
Vehicle ≤ 8,500	\$8,000
8,500 < vehicle ≤ 14,000...................................	\$10,000
14,000 < vehicle ≤ 26,000.................................	\$20,000
26,000 < vehicle	\$40,000

In the case of a fuel cell vehicle weighing less than 8,500 pounds and placed in service after December 31, 2009, the \$8,000 amount in Table 2, above is reduced to \$4,000.

Table 3, below, shows the additional credits for passenger automobiles or light trucks.

[51] See discussion surrounding Table 7, below.

Table 3.–Credit for Qualified Fuel Cell Vehicles

Credit	If Fuel Economy of the Fuel Cell Vehicle Is:	
	at least	but less than
$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	275% of base fuel economy
$3,500	275% of base fuel economy	300% of base fuel economy
$4,000	300% of base fuel economy	

Hybrid vehicles and advanced lean burn technology vehicles

Qualified hybrid vehicle

A qualified hybrid vehicle is a motor vehicle that draws propulsion energy from on-board sources of stored energy that include both an internal combustion engine or heat engine using combustible fuel and a rechargeable energy storage system (e.g., batteries). A qualified hybrid vehicle must be placed in service before January 1, 2011 (January 1, 2010 in the case of a hybrid vehicle weighing more than 8,500 pounds).

Hybrid vehicles that are automobiles and light trucks

In the case of an automobile or light truck (vehicles weighing 8,500 pounds or less), the amount of credit for the purchase of a hybrid vehicle is the sum of two components: (1) a fuel economy credit amount that varies with the rated fuel economy of the vehicle compared to a 2002 model year standard and (2) a conservation credit based on the estimated lifetime fuel savings of the qualified vehicle compared to a comparable 2002 model year vehicle that is powered solely by a gasoline or diesel internal combustion engine. A qualified hybrid automobile or light truck must have a maximum available power[52] from the rechargeable energy storage system of at least four percent. In addition, the vehicle must meet or exceed certain Environmental Protection Agency ("EPA") emissions standards. For a vehicle with a gross vehicle weight rating of 6,000 pounds or less the applicable emissions standards are the Bin 5 Tier II emissions standards. For a vehicle with a gross vehicle weight rating greater than 6,000

[52] For hybrid passenger vehicles and light trucks, the term "maximum available power" means the maximum power available from the rechargeable energy storage system, during a standard 10 second pulse power or equivalent test, divided by such maximum power and the SAE net power of the heat engine. Sec. 30B(d)(3)(C)(i).

pounds and less than or equal to 8,500 pounds, the applicable emissions standards are the Bin 8 Tier II emissions standards.

Table 4, below, shows the fuel economy credit available to a hybrid passenger automobile or light truck whose fuel economy (on a gasoline gallon equivalent basis) exceeds that of a base fuel economy.

Table 4.–Fuel Economy Credit

Credit	If Fuel Economy of the Hybrid Vehicle Is: at least	but less than
$400	125% of base fuel economy	150% of base fuel economy
$800	150% of base fuel economy	175% of base fuel economy
$1,200	175% of base fuel economy	200% of base fuel economy
$1,600	200% of base fuel economy	225% of base fuel economy
$2,000	225% of base fuel economy	250% of base fuel economy
$2,400	250% of base fuel economy	

Table 5, below, shows the conservation credit.

Table 5.–Conservation Credit

Estimated Lifetime Fuel Savings (gallons of gasoline)	Conservation Amount
At least 1,200 but less than 1,800	$250
At least 1,800 but less than 2,400	$500
At least 2,400 but less than 3,000	$750
At least 3,000	$1,000

Advanced lean burn technology vehicles

The amount of credit for the purchase of an advanced lean burn technology vehicle is the sum of two components: (1) a fuel economy credit amount that varies with the rated fuel economy of the vehicle compared to a 2002 model year standard as described in Table 4, above, and (2) a conservation credit based on the estimated lifetime fuel savings of a qualified vehicle compared to a comparable 2002 model year vehicle as described in Table 5, above. The amounts of the credits are determined after an adjustment is made to account for the different BTU content of gasoline and the fuel utilized by the lean burn technology vehicle.

A qualified advanced lean burn technology vehicle is a passenger automobile or a light truck that incorporates direct injection, achieves at least 125 percent of the 2002 model year city fuel economy, and for 2004 and later model vehicles meets or exceeds certain Environmental

Protection Agency emissions standards. For a vehicle with a gross vehicle weight rating of 6,000 pounds or less the applicable emissions standards are the Bin 5 Tier II emissions standards. For a vehicle with a gross vehicle weight rating greater than 6,000 pounds and less than or equal to 8,500 pounds, the applicable emissions standards are the Bin 8 Tier II emissions standards. A qualified advanced lean burn technology vehicle must be placed in service before January 1, 2011.Limitation on number of qualified hybrid and advanced lean burn technology vehicles eligible for the credit

There is a limitation on the number of qualified hybrid vehicles and advanced lean burn technology vehicles sold by each manufacturer of such vehicles that are eligible for the credit. Taxpayers may claim the full amount of the allowable credit up to the end of the first calendar quarter after the quarter in which the manufacturer records the 60,000th hybrid and advanced lean burn technology vehicle sale occurring after December 31, 2005. Taxpayers may claim one half of the otherwise allowable credit during the two calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale. In the third and fourth calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale, the taxpayer may claim one quarter of the otherwise allowable credit.

Thus, for example, summing the sales of qualified hybrid vehicles of all weight classes and all sales of qualified advanced lean burn technology vehicles, if a manufacturer records the sale of its 60,000th qualified vehicle in February of 2007, taxpayers purchasing such vehicles from the manufacturer may claim the full amount of the credit on their purchases of qualified vehicles through June 30, 2007. For the period July 1, 2007, through December 31, 2007, taxpayers may claim one half of the otherwise allowable credit on purchases of qualified vehicles of the manufacturer. For the period January 1, 2008, through June 30, 2008, taxpayers may claim one quarter of the otherwise allowable credit on the purchases of qualified vehicles of the manufacturer. After June 30, 2008, no credit may be claimed for purchases of hybrid vehicles or advanced lean burn technology vehicles sold by the manufacturer.

<u>Hybrid vehicles that are medium and heavy trucks</u>

In the case of a qualified hybrid vehicle weighing more than 8,500 pounds, the amount of credit is determined by the estimated increase in fuel economy and the incremental cost of the hybrid vehicle compared to a comparable vehicle powered solely by a gasoline or diesel internal combustion engine and that is comparable in weight, size, and use of the vehicle. For a vehicle that achieves a fuel economy increase of at least 30 percent but less than 40 percent, the credit is equal to 20 percent of the incremental cost of the hybrid vehicle. For a vehicle that achieves a fuel economy increase of at least 40 percent but less than 50 percent, the credit is equal to 30 percent of the incremental cost of the hybrid vehicle. For a vehicle that achieves a fuel economy increase of 50 percent or more, the credit is equal to 40 percent of the incremental cost of the hybrid vehicle.

The credit is subject to certain maximum applicable incremental cost amounts. For a qualified hybrid vehicle weighing more than 8,500 pounds but not more than 14,000 pounds, the maximum allowable incremental cost amount is $7,500. For a qualified hybrid vehicle weighing more than 14,000 pounds but not more than 26,000 pounds, the maximum allowable incremental cost amount is $15,000. For a qualified hybrid vehicle weighing more than 26,000 pounds, the maximum allowable incremental cost amount is $30,000.

A qualified hybrid vehicle weighing more than 8,500 pounds but not more than 14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 10 percent. A qualified hybrid vehicle weighing more than 14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 15 percent.[53]

Alternative fuel vehicle

The credit for the purchase of a new alternative fuel vehicle is 50 percent of the incremental cost of such vehicle, plus an additional 30 percent if the vehicle meets certain emissions standards. The incremental cost of any new qualified alternative fuel vehicle is the excess of the manufacturer's suggested retail price for such vehicle over the price for a gasoline or diesel fuel vehicle of the same model. To be eligible for the credit, a qualified alternative fuel vehicle must be purchased before January 1, 2011.

The amount of the credit varies depending on the weight of the qualified vehicle. The credit is subject to certain maximum applicable incremental cost amounts. Table 6, below, shows the maximum permitted incremental cost for the purpose of calculating the credit for alternative fuel vehicles by vehicle weight class as well as the maximum credit amount for such vehicles.

Table 6.–Maximum Allowable Incremental Cost for Calculation of Alternative Fuel Vehicle Credit

Vehicle Gross Weight Rating (pounds)	Maximum Allowable Incremental Cost	Maximum Allowable Credit
Vehicle ≤ 8,500	$5,000	$4,000
8,500 < vehicle ≤ 14,000	$10,000	$8,000
14,000 < vehicle ≤ 26,000	$25,000	$20,000
26,000 < vehicle	$40,000	$32,000

Alternative fuels comprise compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid fuel that is at least 85 percent methanol. Qualified

---

[53] In the case of such heavy-duty hybrid motor vehicles, the percentage of maximum available power is computed by dividing the maximum power available from the rechargeable energy storage system during a standard 10-second pulse power test, divided by the vehicle's total traction power. A vehicle's total traction power is the sum of the peak power from the rechargeable energy storage system and the heat (e.g., internal combustion or diesel) engine's peak power. If the rechargeable energy storage system is the sole means by which the vehicle can be driven, then the total traction power is the peak power of the rechargeable energy storage system.

alternative fuel vehicles are vehicles that operate only on qualified alternative fuels and are incapable of operating on gasoline or diesel (except to the extent gasoline or diesel fuel is part of a qualified mixed fuel, described below).

Certain mixed fuel vehicles, that is vehicles that use a combination of an alternative fuel and a petroleum-based fuel, are eligible for a reduced credit. If the vehicle operates on a mixed fuel that is at least 75 percent alternative fuel, the vehicle is eligible for 70 percent of the otherwise allowable alternative fuel vehicle credit. If the vehicle operates on a mixed fuel that is at least 90 percent alternative fuel, the vehicle is eligible for 90 percent of the otherwise allowable alternative fuel vehicle credit.

Base fuel economy

The base fuel economy is the 2002 model year city fuel economy by vehicle type and vehicle inertia weight class. For this purpose, "vehicle inertia weight class" has the same meaning as when defined in regulations prescribed by the EPA for purposes of Title II of the Clean Air Act. Table 7, below, shows the 2002 model year city fuel economy for vehicles by type and by inertia weight class.

Table 7.–2002 Model Year City Fuel Economy

Vehicle Inertia Weight Class (pounds)	Passenger Automobile (miles per gallon)	Light Truck (miles per gallon)
1,500	45.2	39.4
1,750	45.2	39.4
2,000	39.6	35.2
2,250	35.2	31.8
2,500	31.7	29.0
2,750	28.8	26.8
3,000	26.4	24.9
3,500	22.6	21.8
4,000	19.8	19.4
4,500	17.6	17.6
5,000	15.9	16.1
5,500	14.4	14.8
6,000	13.2	13.7
6,500	12.2	12.8
7,000	11.3	12.1
8,500	11.3	12.1

Other rules

The portion of the credit attributable to vehicles of a character subject to an allowance for depreciation is treated as a portion of the general business credit; the remainder of the credit is allowable to the extent of the excess of the regular tax (reduced by certain other credits) over the alternative minimum tax for the taxable year.

Explanation of Provision

Treatment of alternative motor vehicle credit as a personal credit

The provision modifies the alternative motor vehicle credit by treating the nonbusiness portion of that credit as a personal credit. As a result, in the event Congress extends the provision allowing personal credits to offset the alternative minimum tax, the alternative motor vehicle credit will be allowable against the alternative minimum tax.

Plug-in electric drive motor vehicle credit

The provision allows a credit for each qualified plug-in electric drive motor vehicle placed in service. A qualified plug-in electric drive motor vehicle is a motor vehicle that meets certain emissions standards and is propelled to a significant extent by an electric motor that draws electricity from a battery that (1) has a capacity of at least four kilowatt-hours and (2) is capable of being recharged from an external source of electricity. Qualified vehicles must have a gross weight of less than 14,000 pounds. In addition, qualified vehicles weighing less than 8,500 pounds must be passenger automobiles or light trucks.

The base amount of the plug-in electric drive motor vehicle credit is $3,000. If the qualified vehicle draws propulsion from a battery with at least five kilowatt-hours of capacity, the credit amount is increased by $200, plus another $200 for each kilowatt-hour of battery capacity in excess of five kilowatt-hours, up to a maximum additional credit of $2,000.

In general, the credit is available to the vehicle owner, including the lessor of a vehicle subject to lease. If the qualified vehicle is used by certain tax-exempt organizations, governments, or foreign persons and is not subject to a lease, the seller of the vehicle may claim the credit so long as the seller clearly discloses to the user in a document the amount that is allowable as a credit. A vehicle must be used predominantly in the United States to qualify for the credit.

There is a limitation on the number of qualified plug-in electric drive motor vehicles sold by each manufacturer of such vehicles that are eligible for the credit. Taxpayers may claim the full amount of the allowable credit up to the end of the first calendar quarter after the quarter in which the manufacturer records the 60,000th plug-in electric drive motor vehicle sale. Taxpayers may claim one half of the otherwise allowable credit during the two calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale. In the third and fourth calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale, the taxpayer may claim one quarter of the otherwise allowable credit.

The basis of any qualified vehicle is reduced by the amount of the credit. To the extent a vehicle is eligible for credit as a qualified plug-in electric drive motor vehicle, it is not eligible for credit as a qualified hybrid vehicle under section 30B. The portion of the credit attributable to vehicles of a character subject to an allowance for depreciation is treated as part of the general business credit; the nonbusiness portion of the credit is allowable to the extent of the excess of the regular tax and the alternative minimum tax (reduced by certain other credits) for the taxable year.

Effective Date

The plug-in electric drive motor vehicle credit provision is effective for taxable years beginning after December 31, 2007. The provision treating the nonbusiness portion of the alternative motor vehicle credit as a personal credit is effective for taxable years beginning after December 31, 2006.

9. Exclusion from heavy vehicle excise tax for idling reduction units and advanced insulation (sec. 1529 of the bill and sec. 4051 of the Code)

Present Law

A 12 percent excise tax (the "heavy vehicle excise tax") is imposed on the first retail sale of automobile truck chassis and bodies, truck trailer and semitrailer chassis and bodies, and tractors of the kind chiefly used for highway transportation in combination with a trailer or semitrailer.[54] The heavy vehicle excise tax does not apply to automobile truck chassis and bodies suitable for use with a vehicle which has a gross vehicle weight of 33,000 pounds or less. The tax also does not apply to truck trailer and semitrailer chassis and bodies suitable for use with a trailer or semitrailer which has a gross vehicle weight of 26,000 pounds or less, or to tractors having a gross vehicle weight of 19,500 pounds or less if such tractor in combination with a trailer or semitrailer has a gross combined weight of 33,000 pounds or less.

If the owner, lessee, or operator of a taxable article installs any part or accessory within six months after the date such vehicle was first placed in service, a 12 percent tax applies on the price of such part or accessory and its installation.

Explanation of Provision

The provision provides an exemption from the heavy vehicle excise tax for the cost of qualifying idling reduction devices. A qualifying idling reduction device means any device that (1) is installed on automobile truck chassis and bodies, truck trailer or semitrailer chassis and bodies, or tractors, which are subject to the heavy vehicle excise tax, (2) is designed to provide such vehicle those services (such as heat, air conditioning, or electricity) that would otherwise require the operation of the main drive engine while the vehicle is temporarily parked or remains stationary using either (i) an all electric unit, such as a battery powered unit or from grid-supplied electricity, or (ii) a dual fuel unit powered by diesel or other fuels, and capable of providing such services from grid-supplied electricity or on-truck batteries alone, and (3) is certified by the Secretary of Energy, in consultation with the Environmental Protection Agency and the Secretary of Transportation, to reduce long-duration idling of such vehicle at a motor vehicle rest stop or other location where such vehicles are temporarily parked or remain stationary. Long duration idling means the operation of a main drive engine for a period greater than 15 consecutive minutes, when the main drive engine is not engaged in gear. Such term does not apply to routine stoppages associated with traffic movement or congestion.

The provision also provides an exemption for the installation of "advanced insulation" in a commercial refrigerated truck or trailer that is subject to the heavy vehicle excise tax. Advanced insulation means insulation that has an R value of not less than R35 per inch.

Both exemptions apply regardless of whether the device or insulation is factory installed or later added as an accessory.

[54] Sec. 4051.

Effective Date

The provision is effective for retail sales or installations made after December 31, 2007.

10. Restructure New York Liberty Zone tax incentives (sec. 1530 of the bill and secs. 1400K and 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.[55]

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.[56] 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")[57] apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section

---

[55] 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.

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

[57] 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.

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 leasehold improvement property[58] 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 purchase[59] 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.[60]

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, 2006[61] (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

[58] 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).

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

[60] 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.

[61] December 31, 2009 with respect to qualified nonresidential real property and residential rental property.

longer than the term of the lease.[62] This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service.[63] 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.[64]

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.

<u>Increased section 179 expensing for qualified New York Liberty Zone property</u>

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs under section 179. The Small Business and Work Opportunity Tax Act of 2007[65] increased the amount a taxpayer may deduct, for taxable years beginning in 2007 through 2010, to $125,000 of the cost of qualifying property placed in service for the taxable year.[66] 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. Off-the-shelf

---

[62] 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 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.

[63] 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.

[64] 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).

[65] Pub. L. No. 110-28, sec. 8212 (2007).

[66] Additional section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)).

computer software placed in service in taxable years beginning before 2010 is treated as qualifying property. The $125,000 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 $500,000. The $125,000 and $500,000 amounts are indexed for inflation in taxable years beginning after 2007 and before 2011.[67] 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.

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 property[68] 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.[69]

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.

---

[67] For taxable years beginning in 2011 and thereafter (or before 2003), the following rules apply. 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. The $25,000 and $200,000 amounts are not indexed for inflation.

[68] As defined in sec. 179(d)(1).

[69] See Rev. Proc. 2002-33, 2002-1 C.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.

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.[70] 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.[71] The replacement period is extended to three years if the converted property is real property held for the productive use in a trade or business or for investment.[72]

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 the first-year depreciation allowance of 30 percent and the additional section 179 expensing in the case of nonresidential real property and residential rental property as of the date of enactment of this provision.[73]

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

---

[70] Sec. 1033(a).

[71] Sec. 1033(a)(2)(B).

[72] Sec. 1033(g)(4).

[73] In the case of nonresidential real property and residential rental property acquired pursuant to a binding contract in effect on such enactment date, the first-year depreciation allowance of 30 percent and the additional section 179 expensing provisions terminate on December 31, 2009.

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, 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.

The Governor of the State of New York and the Mayor of the City of New York are to jointly allocate to each New York Liberty Zone governmental unit the portion of the qualifying expenditure amount that 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 12-year period beginning on January 1, 2008. Aggregate amounts allocated may not exceed $2 billion during the credit period. There is also an annual limit on allocations equal to (1) $115 million for each year in the first ten years of the credit period, plus (2) any amounts in (1) that were authorized to be allocated for prior calendar years in the credit period but not so allocated. The annual limit for each of the last two years of the credit period is $425 million, plus any amounts 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. 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.

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, 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.

11. Extension of transportation fringe benefit to bicycle commuters (sec. 1531 of the bill and sec. 132 of the Code)

Present Law

Qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income.[74] Qualified transportation fringe benefits include parking, transit passes, and vanpool benefits. In addition, no amount is includible in income of an employee merely because the employer offers the employee a choice between cash and qualified transportation fringe benefits. Up to $215 (for 2007) per month of employer-provided parking is excludable from income. Up to $110 (for 2007) per month of employer-provided transit and vanpool benefits are excludable from gross income. These amounts are indexed annually for inflation, rounded to the nearest multiple of $5.

Under present law, qualified transportation fringe benefits include a cash reimbursement by an employer to an employee. However, in the case of transit passes, a cash reimbursement is considered a qualified transportation fringe benefit only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.

Explanation of Provision

The provision adds a qualified bicycle commuting reimbursement fringe benefit as a qualified transportation fringe benefit. A qualified bicycle commuting reimbursement fringe benefit means, with respect to a calendar year, any employer reimbursement during the 15-month period beginning with the first day of such calendar year of an employee for reasonable expenses incurred by the employee during the calendar year for the purchase and repair of a bicycle, bicycle improvements, and bicycle storage, provided that the bicycle is regularly used for travel between the employee's residence and place of employment.

The maximum amount that can be excluded from an employee’s gross income for a calendar year on account of a bicycle commuting reimbursement fringe benefit is the applicable annual limitation for the employee for that calendar year. The applicable annual limitation for an employee for a calendar year is equal to the product of $20 multiplied by the number of the employee’s qualified bicycle commuting months for the year. The $20 amount is not indexed for inflation. A qualified bicycle commuting month means with respect to an employee any month for which the employee does not receive any other qualified transportation fringe benefit and during which the employee regularly uses a bicycle for a substantial portion of travel between the employee’s residence and place of employment. Thus, no amount is credited towards an employee’s applicable annual limitation for any month in which an employee’s usage of a bicycle is infrequent or constitutes an insubstantial portion of the employee’s commute.

A bicycle commuting reimbursement fringe benefit cannot be funded by an elective salary contribution on the part of an employee.

---

[74] Code sec. 132(f).

Effective Date

The provision is effective for taxable years beginning after December 31, 2007.

C. Energy Conservation and Efficiency Provisions

1. Qualified energy conservation bonds (sec. 1541 of the bill and new sec. 54C of the Code)

Present law

Tax-exempt bonds

In general

Subject to certain Code restrictions, interest on bonds issued by State and local government generally is excluded from gross income for Federal income tax purposes. Bonds issued by State and local governments may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons. For this purpose, the term "nongovernmental person" generally includes the Federal Government and all other individuals and entities other than States or local governments. The exclusion from income for interest on State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds") and other Code requirements are met.

Private activity bond tests

Present law provides two tests for determining whether a State or local bond is in substance a private activity bond, the private business test and the private loan test.[75]

Private business tests

Private business use and private payments result in State and local bonds being private activity bonds if both parts of the two-part private business test are satisfied–

1. More than 10 percent of the bond proceeds is to be used (directly or indirectly) by a private business (the "private business use test"); and

2. More than 10 percent of the debt service on the bonds is secured by an interest in property to be used in a private business use or to be derived from payments in respect of such property (the "private payment test").[76]

---

[75] Sec. 141(b) and (c).

[76] The 10-percent private business use and payment threshold is reduced to five percent for private business uses that are unrelated to a governmental purpose also being financed with proceeds of the bond issue. In addition, as described more fully below, the 10-percent private business use and private payment thresholds are phased-down for larger bond issues for the financing of certain "output" facilities. The term output facility includes electric generation, transmission, and distribution facilities.

Private business use generally includes any use by a business entity (including the Federal government), which occurs pursuant to terms not generally available to the general public. For example, if bond-financed property is leased to a private business (other than pursuant to certain short-term leases for which safe harbors are provided under Treasury regulations), bond proceeds used to finance the property are treated as used in a private business use, and rental payments are treated as securing the payment of the bonds. Private business use also can arise when a governmental entity contracts for the operation of a governmental facility by a private business under a management contract that does not satisfy Treasury regulatory safe harbors regarding the types of payments made to the private operator and the length of the contract.[77]

Private loan test

The second standard for determining whether a State or local bond is a private activity bond is whether an amount exceeding the lesser of (1) five percent of the bond proceeds or (2) $5 million is used (directly or indirectly) to finance loans to private persons. Private loans include both business and other (e.g., personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test. Present law provides that the substance of a transaction governs in determining whether the transaction gives rise to a private loan. In general, any transaction which transfers tax ownership of property to a private person is treated as a loan.

Qualified private activity bonds

As stated, interest on private activity bonds is taxable unless the bonds meet the requirements for qualified private activity bonds. Qualified private activity bonds permit States or local governments to act as conduits providing tax-exempt financing for certain private activities. The definition of qualified private activity bonds includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond.[78] The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); qualified residential rental projects; privately owned and/or operated utility facilities (sewage, water, solid waste disposal, and local district heating and cooling facilities, certain private electric and gas facilities, and hydroelectric dam enhancements); public/private educational facilities; qualified green building and sustainable design projects; and qualified highway or surface freight transfer facilities.[79]

In most cases, the aggregate volume of these tax-exempt private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each

[77] See Treas. Reg. sec. 1.141-3(b)(4); Rev. Proc. 97-13, 1997-1 C.B. 632.

[78] Sec. 141(e).

[79] Sec. 142(a).

State. For calendar year 2007, the State volume cap, which is indexed for inflation, equals $85 per resident of the State, or $256.24 million, if greater.

Arbitrage restrictions

The tax exemption for State and local bonds also does not apply to any arbitrage bond.[80] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.[81] 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, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

Indian tribal governments

Indian tribal governments are provided with a tax status similar to State and local governments for specified purposes under the Code.[82] Among the purposes for which a tribal government is treated as a State is the issuance of tax-exempt bonds. However, bonds issued by tribal governments are subject to limitations not imposed on State and local government issuers. Tribal governments are authorized to issue tax-exempt bonds only if substantially all of the proceeds are used for essential governmental functions or certain manufacturing facilities.[83]

Clean renewable energy bonds

As an alternative to traditional tax-exempt bonds, States and local governments may issue clean renewable energy bonds ("CREBs"). CREBs are defined as any bond 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 by qualified borrowers for qualified projects. "Qualified projects" are facilities that qualify for the tax credit under section 45 (other than Indian coal production facilities), without regard to the placed-in-service date requirements of that section.[84] The term "qualified issuers" includes (1) governmental bodies (including Indian tribal governments); (2) mutual or cooperative electric companies (described in section

[80] Sec. 103(a) and (b)(2).

[81] Sec. 148.

[82] Sec. 7871.

[83] Sec. 7871(c).

[84] In addition, Notice 2006-7 provides that qualified projects include any facility owned by a qualified borrower that is functionally related and subordinate to any facility described in section 45(d)(1) through (d)(9) and owned by such qualified borrower.

501(c)(12) or section 1381(a)(2)(C), or a not-for-profit electric utility which has received a loan or guarantee under the Rural Electrification Act); and (3) clean renewable energy bond lenders. The term "qualified borrower" includes a governmental body (including an Indian tribal government) and a mutual or cooperative electric company. A clean renewable energy bond lender means a cooperative which is owned by, or has outstanding loans to, 100 or more cooperative electric companies and is in existence on February 1, 2002.

Unlike tax-exempt bonds, CREBs are not interest-bearing obligations. Rather, the taxpayer holding CREBs on a credit 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 rate on the bonds is determined by the Secretary and is to be a rate that permits issuance of CREBs without discount and interest cost to the qualified issuer. The credit accrues quarterly and is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability.

CREBs are subject to a maximum maturity limitation. The maximum maturity is the term which the Secretary estimates will result in the present value of the obligation to repay the principal on a CREBs being equal to 50 percent of the face amount of such bond. In addition, the Code requires level amortization of CREBs during the period such bonds are outstanding.

CREBs also are subject to the arbitrage requirements of section 148 that apply to traditional tax-exempt bonds. Principles under section 148 and the regulations thereunder apply for purposes of determining the yield restriction and arbitrage rebate requirements applicable to CREBs.

In addition to the above requirements, at least 95 percent of the proceeds of CREBs must be spent 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 CREBs if unspent proceeds are used within 90 days from the end of such five-year period to redeem any "nonqualified bonds." The five-year spending period may be extended by the Secretary upon the qualified issuer's request demonstrating that the failure to satisfy the five-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

Issuers of CREBs are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds. There is a national CREB limitation of $1.2 billion. The maximum amount of CREBs that may be allocated to qualified projects of governmental bodies is $750 million. CREBs must be issued before January 1, 2009.

Explanation of Provision

The provision creates a new category of tax-credit bonds, qualified energy conservation bonds. Qualified energy conservation bonds may be used to finance qualified conservation purposes.

The term "qualified conservation purpose" means:

1. Capital expenditures incurred for purposes of: (A) reducing energy consumption in publicly owned buildings by at least 20 percent; (B) implementing green community programs; or (C) rural development involving the production of electricity from renewable energy sources;

2. Expenditures with respect to facilities or grants that support research in: (A) development of cellulosic ethanol or other nonfossil fuels; (B) technologies for the capture and sequestration of carbon dioxide produced through the use of fossil fuels; (C) increasing the efficiency of existing technologies for producing nonfossil fuels; (D) automobile battery technologies and other technologies to reduce fossil fuel consumption in transportation; and (E) technologies to reduce energy use in buildings;

3. Mass commuting facilities and related facilities that reduce the consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting;

4. Demonstration projects designed to promote the commercialization of: (A) green building technology; (B) conversion of agricultural waste for use in the production of fuel or otherwise; (C) advanced battery manufacturing technologies; (D) technologies to reduce peak-use of electricity; and (E) technologies for the capture and sequestration of carbon dioxide emitted from combusting fossil fuels in order to produce electricity; and

5. Public education campaigns to promote energy efficiency (other than movies, concerts, and other events held primarily for entertainment purposes).

There is a national limitation on qualified energy conservation bonds of $3 billion. Allocations of qualified energy conservation bonds are made to the States with sub-allocations to large local governments. Allocations are made to the States according to their respective populations, reduced by any sub-allocations to large local governments (defined below) within the States. Sub-allocations to large local governments shall be an amount of the national qualified energy conservation bond limitation that bears the same ratio to the amount of such limitation that otherwise would be allocated to the State in which such large local government is located as the population of such large local government bears to the population of such State. The term large local government means: any municipality or county if such municipality or county has a population of 100,000 or more. Indian tribal governments also are treated as large local governments for these purposes (without regard to population).

Each State or large local government receiving an allocation of qualified energy conservation bonds may further allocate issuance authority to issuers within such State or large local government. However, any allocations to issuers within the State or large local government shall be made in a manner that results in not less than 70 percent of the allocation of qualified energy conservation bonds to such State or large local government being used to designate bonds that are not private activity bonds (i.e., the bond cannot meet the private business tests or the private loan test of section 141).

Under the provision, 100 percent of the available project proceeds of qualified energy conservation bonds must be used for qualified conservation purposes. In the case of qualified conservation bonds issued as private activity bonds, 100 percent of the available project proceeds must be used for capital expenditures. In addition, qualified energy conservation bonds only may be issued by Indian tribal governments to the extent such bonds are issued for purposes that satisfy the present law requirements for tax-exempt bonds issued by Indian tribal governments (i.e., essential governmental functions and certain manufacturing purposes).

The provision requires 100 percent of the available project proceeds of qualified energy conservation bonds to be used within the three-year period that begins on the date of issuance. The provision defines available project proceeds as proceeds from the sale of the issue less issuance costs (not to exceed two percent) and any investment earnings on such sale proceeds. To the extent less than 100 percent of the available project proceeds are used to finance qualified conservation purposes during the three-year spending period, bonds will continue to qualify as qualified energy conservation bonds if unspent proceeds are used within 90 days from the end of such three-year period to redeem bonds. The three-year spending period may be extended by the Secretary upon the issuer's request demonstrating that the failure to satisfy the three-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

Qualified energy conservation bonds generally are subject to the arbitrage requirements of section 148. However, available project proceeds invested during the three-year spending period are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). In addition, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded at a rate not more rapid than equal annual installments; (2) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and (3) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified energy conservation bonds are issued.

The maturity of qualified energy conservation bonds is the term that the Secretary estimates will result in the present value of the obligation to repay the principal on such bonds being equal to 50 percent of the face amount of such bonds, using as a discount rate the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified energy conservation bonds are issued.

As with present-law tax credit bonds, the taxpayer holding qualified energy conservation bonds on a credit allowance date is entitled to a tax credit. However, the credit rate is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of qualified energy conservation bonds without discount and interest cost to the issuer. The amount of the tax credit to the holder is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit accrues quarterly, is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits in one year may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

Issuers of qualified energy conservation bonds are required to certify that the financial disclosure requirements that apply to State and local bonds offered for sale to the general public are satisfied with respect to any Federal, State, or local government official directly involved with the issuance of such bonds. The provision authorizes the Secretary to impose additional financial reporting requirements by regulation.[85]

Effective Date

The provision is effective for bonds issued after the date of enactment.

2. Qualified forestry conservation bonds (sec. 1542 of the bill and new sec. 54D of the Code)

Present law

Tax-exempt bonds

In general

Subject to certain Code restrictions, interest on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes. Bonds issued by State and local governments may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons. For this purpose, the term "nongovernmental person" generally includes the Federal Government and all other individuals and entities other than States or local governments. The exclusion from income for interest on State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds") and other Code requirements are met.

Private activity bond tests

Present law provides two tests for determining whether a State or local bond is in substance a private activity bond, the private business test and the private loan test.[86]

Private business tests

Private business use and private payments result in State and local bonds being private activity bonds if both parts of the two-part private business test are satisfied–

---

[85] A technical correction may be necessary to clarify the application of this requirement to qualified energy conservation bonds.

[86] Sec. 141(b) and (c).

1. More than 10 percent of the bond proceeds is to be used (directly or indirectly) by a private business (the "private business use test"); and

2. More than 10 percent of the debt service on the bonds is secured by an interest in property to be used in a private business use or to be derived from payments in respect of such property (the "private payment test").[87]

Private business use generally includes any use by a business entity (including the Federal government), which occurs pursuant to terms not generally available to the general public. For example, if bond-financed property is leased to a private business (other than pursuant to certain short-term leases for which safe harbors are provided under Treasury regulations), bond proceeds used to finance the property are treated as used in a private business use, and rental payments are treated as securing the payment of the bonds. Private business use also can arise when a governmental entity contracts for the operation of a governmental facility by a private business under a management contract that does not satisfy Treasury regulatory safe harbors regarding the types of payments made to the private operator and the length of the contract.[88]

<u>Private loan test</u>

The second standard for determining whether a State or local bond is a private activity bond is whether an amount exceeding the lesser of (1) five percent of the bond proceeds or (2) $5 million is used (directly or indirectly) to finance loans to private persons. Private loans include both business and other (e.g., personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test. Present law provides that the substance of a transaction governs in determining whether the transaction gives rise to a private loan. In general, any transaction which transfers tax ownership of property to a private person is treated as a loan.

<u>Qualified private activity bonds</u>

As stated, interest on private activity bonds is taxable unless the bonds meet the requirements for qualified private activity bonds. Qualified private activity bonds permit States or local governments to act as conduits providing tax-exempt financing for certain private activities. The definition of qualified private activity bonds includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan

---

[87] The 10-percent private business use and payment threshold is reduced to five percent for private business uses that are unrelated to a governmental purpose also being financed with proceeds of the bond issue. In addition, as described more fully below, the 10-percent private business use and private payment thresholds are phased-down for larger bond issues for the financing of certain "output" facilities. The term output facility includes electric generation, transmission, and distribution facilities.

[88] See Treas. Reg. sec. 1.141-3(b)(4); Rev. Proc. 97-13, 1997-1 C.B. 632.

bond.[89] The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); qualified residential rental projects; privately owned and/or operated utility facilities (sewage, water, solid waste disposal, and local district heating and cooling facilities, certain private electric and gas facilities, and hydroelectric dam enhancements); public/private educational facilities; qualified green building and sustainable design projects; and qualified highway or surface freight transfer facilities.[90]

In most cases, the aggregate volume of these tax-exempt private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. For calendar year 2007, the State volume cap, which is indexed for inflation, equals $85 per resident of the State, or $256.24 million, if greater.

Arbitrage restrictions

The tax exemption for State and local bonds also does not apply to any arbitrage bond.[91] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.[92] 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, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government.

Indian tribal governments

Indian tribal governments are provided with a tax status similar to State and local governments for specified purposes under the Code.[93] Among the purposes for which a tribal government is treated as a State is the issuance of tax-exempt bonds. However, bonds issued by tribal governments are subject to limitations not imposed on State and local government issuers. Tribal governments are authorized to issue tax-exempt bonds only if substantially all of the proceeds are used for essential governmental functions or certain manufacturing facilities.[94]

---

[89] Sec. 141(e).

[90] Sec. 142(a).

[91] Sec. 103(a) and (b)(2).

[92] Sec. 148.

[93] Sec. 7871.

[94] Sec. 7871(c).

<u>Clean renewable energy bonds</u>

As an alternative to traditional tax-exempt bonds, States and local governments may issue clean renewable energy bonds ("CREBs"). CREBs are defined as any bond 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 by qualified borrowers for qualified projects. "Qualified projects" are facilities that qualify for the tax credit under section 45 (other than Indian coal production facilities), without regard to the placed-in-service date requirements of that section.[95] The term "qualified issuers" includes (1) governmental bodies (including Indian tribal governments); (2) mutual or cooperative electric companies (described in section 501(c)(12) or section 1381(a)(2)(C), or a not-for-profit electric utility which has received a loan or guarantee under the Rural Electrification Act); and (3) clean renewable energy bond lenders. The term "qualified borrower" includes a governmental body (including an Indian tribal government) and a mutual or cooperative electric company. A clean renewable energy bond lender means a cooperative which is owned by, or has outstanding loans to, 100 or more cooperative electric companies and is in existence on February 1, 2002.

Unlike tax-exempt bonds, CREBs are not interest-bearing obligations. Rather, the taxpayer holding CREBs on a credit 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 rate on the bonds is determined by the Secretary and is to be a rate that permits issuance of CREBs without discount and interest cost to the qualified issuer. The credit accrues quarterly and is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability.

CREBs are subject to a maximum maturity limitation. The maximum maturity is the term which the Secretary estimates will result in the present value of the obligation to repay the principal on a CREBs being equal to 50 percent of the face amount of such bond. In addition, the Code requires level amortization of CREBs during the period such bonds are outstanding.

CREBs also are subject to the arbitrage requirements of section 148 that apply to traditional tax-exempt bonds. Principles under section 148 and the regulations thereunder apply for purposes of determining the yield restriction and arbitrage rebate requirements applicable to CREBs.

In addition to the above requirements, at least 95 percent of the proceeds of CREBs must be spent 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 CREBs if unspent proceeds are used within 90 days from the end of such five-year period to redeem any "nonqualified bonds." The five-year spending period may be extended by the Secretary upon the qualified issuer's request

---

[95] In addition, Notice 2006-7 provides that qualified projects include any facility owned by a qualified borrower that is functionally related and subordinate to any facility described in section 45(d)(1) through (d)(9) and owned by such qualified borrower.

demonstrating that the failure to satisfy the five-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

Issuers of CREBs are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds. There is a national CREB limitation of $1.2 billion. The maximum amount of CREBs that may be allocated to qualified projects of governmental bodies is $750 million. CREBs must be issued before January 1, 2009.

Explanation of Provision

The provision creates a new category of tax-credit bonds, qualified forestry conservation bonds. Qualified forestry conservation bonds are bonds issued by qualified issuers to finance qualified forestry conservation projects. The term "qualified issuer" means a State or a section 501(c)(3) organization. The term "qualified forestry conservation project" means the acquisition by a State or section 501(c)(3) organization from an unrelated person of forest and forest land that meets the following qualifications: (1) some portion of the land acquired must be adjacent to United States Forest Service Land; (2) at least half of the land acquired must be transferred to the United States Forest Service at no net cost and not more than half of the land acquired may either remain with or be donated to a State; (3) all of the land must be subject to a habitat conservation plan for native fish approved by the United States Fish and Wildlife Service; and (4) the amount of acreage acquired must be at least 40,000 acres.

There is a national limitation on qualified forestry conservation bonds of $500 million. Allocations of qualified forestry conservation bonds are among qualified forestry conservation projects in the manner the Secretary determines appropriate so as to ensure that all of such limitation is allocated before the date that is 24 months after the date of enactment. The provision also requires the Secretary to solicit applications for allocations of qualified forestry conservation bonds no later than 90 days after the date of enactment.

The provision requires 100 percent of the available project proceeds of qualified forestry conservation bonds to be used within the three-year period that begins on the date of issuance. The provision defines available project proceeds as proceeds from the sale of the issue less issuance costs (not to exceed two percent) and any investment earnings on such sale proceeds. To the extent less than 100 percent of the available project proceeds are used to finance qualified forestry conservation purposes during the three-year spending period, bonds will continue to qualify as qualified forestry conservation bonds if unspent proceeds are used within 90 days from the end of such three-year period to redeem bonds. The three-year spending period may be extended by the Secretary upon the issuer's request demonstrating that the failure to satisfy the three-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

Qualified forestry conservation bonds generally are subject to the arbitrage requirements of section 148. However, available project proceeds invested during the three-year spending period are not subject to the arbitrage restrictions (i.e., yield restriction and rebate requirements). In addition, amounts invested in a reserve fund are not subject to the arbitrage restrictions to the extent: (1) such fund is funded in a manner reasonably expected to result in an amount not greater than an amount necessary to repay the issue; and (2) the yield on such fund is not greater than the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified forestry conservation bonds are issued.

The maturity of qualified forestry conservation bonds is the term that the Secretary estimates will result in the present value of the obligation to repay the principal on such bonds being equal to 50 percent of the face amount of such bonds, using as a discount rate the average annual interest rate of tax-exempt obligations having a term of 10 years or more that are issued during the month the qualified forestry conservation bonds are issued.

As with present-law tax credit bonds, the taxpayer holding qualified forestry conservation bonds on a credit allowance date is entitled to a tax credit. However, the credit rate is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of qualified forestry conservation bonds without discount and interest cost to the issuer. The amount of the tax credit to the holder is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit accrues quarterly, is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits in one year may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

Issuers of qualified forestry conservation bonds are required to certify that the financial disclosure requirements that apply to State and local bonds offered for sale to the general public are satisfied with respect to any Federal, State, or local government official directly involved with the issuance of such bonds. The provision authorizes the Secretary to impose additional financial reporting requirements by regulation.[96]

Effective Date

The provision is effective for bonds issued after the date of enactment.

3. Extension and modification of energy efficient existing homes credit (sec. 1543 of the bill and sec. 25C of the Code)

Present Law

Section 25C provides a 10-percent credit for the purchase of qualified energy efficiency improvements to existing homes. 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 August 8, 2005 (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

[96] A technical correction may be necessary to clarify the application of this requirement to qualified forestry conservation bonds.

component reasonably can be expected to remain in use for at least five years. The credit is nonrefundable.

Building envelope components are: (1) insulation materials or systems that 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.

Additionally, code section 25C provides specified credits for the purchase of specific energy efficient property. The allowable credit for the purchase of certain property is (1) $50 for each advanced main air circulating fan, (2) $150 for each qualified natural gas, propane, or oil furnace or hot water boiler, and (3) $300 for each item of qualified energy efficient property.

An advanced main air circulating fan is a fan used in a natural gas, propane, or oil furnace originally placed in service by the taxpayer during the taxable year, and which has an annual electricity use of no more than two percent of the total annual energy use of the furnace (as determined in the standard Department of Energy test procedures).

A qualified natural gas, propane, or oil furnace or hot water boiler is a natural gas, propane, or oil furnace or hot water boiler with an annual fuel utilization efficiency rate of at least 95.

Qualified energy-efficient property is: (1) an electric heat pump water heater which yields an energy factor of at least 2.0 in the standard Department of Energy test procedure, (2) an electric heat pump which has a heating seasonal performance factor of at least 9, a seasonal energy efficiency ratio (SEER) of at least 15, and an energy efficiency ratio ("EER") of at least 13, (3) a geothermal heat pump which (i) in the case of a closed loop product, has an EER of at least 14.1 and a heating coefficient of performance ("COP") of at least 3.3, (ii) in the case of an open loop product, has an energy EER of at least 16.2 and a heating COP of at least 3.6, and (iii) in the case of a direct expansion (DX) product, has an EER of at least 15 and a heating COP of at least 3.5, (4) a central air conditioner with energy efficiency of at least the highest efficiency tier established by the Consortium for Energy Efficiency as in effect on Jan. 1, 2006, and (5) a natural gas, propane, or oil water heater which has an energy factor of at least 0.80.

Under section 25C, the maximum credit for a taxpayer with respect to the same dwelling for all taxable years is $500, and no more than $200 of such credit may be attributable to expenditures on windows.

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.

The credit applies to property placed in service prior to January 1, 2008.

Explanation of Provision

The provision extends the credit for one year, through December 31, 2008. The provision adds biomass fuel property to the list of qualified energy efficient building property eligible for a $300 credit. Biomass fuel property is a stove that burns biomass fuel to heat a dwelling unit located in the United States and used as a principal residence by the taxpayer, or to heat water for such dwelling unit, and that has a thermal efficiency rating of at least 75 percent. Biomass fuel is any plant-derived fuel available on a renewable or recurring basis, including agricultural crops and trees, wood and wood waste and residues (including wood pellets), plants (including aquatic plants), grasses, residues, and fibers.

Effective Date

The provision is effective for expenditures after December 31, 2007, for property placed in service prior to January 1, 2008.

4. Energy efficient commercial buildings deduction (sec. 1544 of the bill and sec. 179D of the Code)

Present Law

In general

Section 179D provides a deduction equal to energy-efficient commercial building property expenditures made by the taxpayer. Energy-efficient commercial building property expenditures is defined as property (1) which is installed on or in any building located in the United States that is within the scope of Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America ("ASHRAE/IESNA"), (2) which is installed as part of (i) the interior lighting systems, (ii) the heating, cooling, ventilation, and hot water systems, or (iii) the building envelope, and (3) which is certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building which meets the minimum requirements of Standard 90.1-2001 (as in effect on April 2, 2003). The deduction is limited to an amount equal to $1.80 per square foot of the property for which such expenditures are made. The deduction is allowed in the year in which the property is placed in service.

Certain certification requirements must be met in order to qualify for the deduction. The Secretary, in consultation with the Secretary of Energy, will promulgate regulations that describe methods of calculating and verifying energy and power costs using qualified computer software based on the provisions of the 2005 California Nonresidential Alternative Calculation Method Approval Manual or, in the case of residential property, the 2005 California Residential Alternative Calculation Method Approval Manual.

The Secretary shall prescribe procedures for the inspection and testing for compliance of buildings that are comparable, given the difference between commercial and residential buildings, to the requirements in the Mortgage Industry National Accreditation Procedures for Home Energy Rating Systems. Individuals qualified to determine compliance shall only be those recognized by one or more organizations certified by the Secretary for such purposes.

For energy-efficient commercial building property expenditures made by a public entity, such as public schools, the Secretary shall promulgate regulations that allow the deduction to be allocated to the person primarily responsible for designing the property in lieu of the public entity.

If a deduction is allowed under this section, the basis of the property shall be reduced by the amount of the deduction.

The deduction is effective for property placed in service after December 31, 2005 and prior to January 1, 2009.

Partial allowance of deduction

In the case of a building that does not meet the overall building requirement of a 50-percent energy savings, a partial deduction is allowed with respect to each separate building system that comprises energy efficient property and which is certified by a qualified professional as meeting or exceeding the applicable system-specific savings targets established by the Secretary of the Treasury. The applicable system-specific savings targets to be established by the Secretary are those that would result in a total annual energy savings with respect to the whole building of 50 percent, if each of the separate systems met the system specific target. The separate building systems are (1) the interior lighting system, (2) the heating, cooling, ventilation and hot water systems, and (3) the building envelope. The maximum allowable deduction is $0.60 per square foot for each separate system.

Interim rules for lighting systems

In the case of system-specific partial deductions, in general no deduction is allowed until the Secretary establishes system-specific targets.[97] However, in the case of lighting system retrofits, until such time as the Secretary issues final regulations, the system-specific energy savings target for the lighting system is deemed to be met by a reduction in Lighting Power Density of 40 percent (50 percent in the case of a warehouse) of the minimum requirements in Table 9.3.1.1 or Table 9.3.1.2 of ASHRAE/IESNA Standard 90.1-2001. Also, in the case of a lighting system that reduces lighting power density by 25 percent, a partial deduction of 30 cents per square foot is allowed. A pro-rated partial deduction is allowed in the case of a lighting system that reduces lighting power density between 25 percent and 40 percent. Certain lighting level and lighting control requirements must also be met in order to qualify for the partial lighting deductions under the interim rule.

Explanation of Provision

The provision extends the energy efficient commercial buildings deduction for five years, through December 31, 2013.

---

[97] IRS Notice 2006-52 has set a target of a 16 2/3 percent reduction in total energy and power costs for each of the three subsystems.

Effective Date

The provision is effective on the date of enactment.

5. Extension and modification of energy efficient appliance credit (sec. 1545 of the bill and sec. 45M of the Code)

Present Law

Section 45M provides a credit for the eligible production of certain energy-efficient dishwashers, clothes washers, and refrigerators.

The credit for dishwashers applies to dishwashers produced in 2006 and 2007 that meet the Energy Star standards for 2007. The credit amount equals $3 multiplied by 100 times the "energy savings percentage," but may not exceed $100 per dishwasher. The energy saving percentage is defined as the change in the energy factor ("EF") required by the Energy Star program between 2007 and 2005 divide by the EF requirement for 2007. The EF required in 2005 for the Energy Star program was 0.58 and it was 0.65 in 2007, for a change of 0.07. The energy saving percentage is thus 0.07 / 0.65, which when multiplied by 100 times $3 equals $32.31 per refrigerator.

The credit for clothes washers equals $100 for clothes washers manufactured in 2006-2007 that meet the requirements of the Energy Star program that are in effect for clothes washers in 2007.

The credit for refrigerators is based on energy savings and year of manufacture. The energy savings are determined relative to the energy conservation standards promulgated by the Department of Energy that took effect on July 1, 2001. Refrigerators that achieve a 15 to 20 percent energy saving and that are manufactured in 2006 receive a $75 credit. Refrigerators that achieve a 20 to 25 percent energy saving receive a (i) $125 credit if manufactured in 2006-2007. Refrigerators that achieve at least a 25 percent energy saving receive a (i) $175 credit if manufactured in 2006-2007.

Appliances eligible for the credit include only those produced in the United States and that exceed the average amount of U.S. production from the three prior calendar years for each category of appliance. In the case of refrigerators, eligible production is U.S. production that exceeds 110 percent of the average amount of U.S. production from the three prior calendar years.

A dishwasher is any a residential dishwasher subject to the energy conservation standards established by the Department of Energy. A refrigerator must be an automatic defrost refrigerator-freezer with an internal volume of at least 16.5 cubic feet to qualify for the credit. A clothes washer is any residential clothes washer, including a residential style coin operated washer, that satisfies the relevant efficiency standard.

The taxpayer may not claim credits in excess of $75 million for all taxable years, and may not claim credits in excess of $20 million with respect to clothes washers eligible for the $50 credit and refrigerators eligible for the $75 credit. A taxpayer may elect to increase the $20 million limitation described above to $25 million provided that the aggregate amount of credits with respect to such appliances, plus refrigerators eligible for the $100 and $125 credits, is limited to $50 million for all taxable years.

Additionally, the credit allowed in a taxable year for all appliances may not exceed two percent of the average annual gross receipts of the taxpayer for the three taxable years preceding the taxable year in which the credit is determined.

The credit is part of the general business credit.

Explanation of Provision

The provision extends and modifies the energy efficient appliance credit. The provision provides modified credits for eligible production as follows:

Dishwashers

1. $45 in the case of a dishwasher that is manufactured in calendar year 2008 or 2009 that uses no more than 324 kilowatt hours per year and 5.8 gallons per cycle, and

2. $75 in the case of a dishwasher that is manufactured in calendar year 2008, 2009, or 2010 and that uses no more than 307 kilowatt hours per year and 5.0 gallons per cycle (5.5 gallons per cycle for dishwashers designed for greater than 12 place settings).

Clothes washers

1. $75 in the case of a residential top-loading clothes washer manufactured in calendar year 2008 that meets or exceeds a 1.72 modified energy factor and does not exceed a 8.0 water consumption factor, and

2. $125 in the case of a residential top-loading clothes washer manufactured in calendar year 2008 or 2009 that meets or exceeds a 1.8 modified energy factor and does not exceed a 7.5 water consumption factor,

3. $150 in the case of a residential or commercial clothes washer manufactured in calendar year 2008, 2009 or 2010 that meets or exceeds a 2.0 modified energy factor and does not exceed a 6.0 water consumption factor, and

4. $250 in the case of a residential or commercial clothes washer manufactured in calendar year 2008, 2009, or 2010 that meets or exceeds a 2.2 modified energy factor and does not exceed a 4.5 water consumption factor.

Refrigerators

1. $50 in the case of a refrigerator manufactured in calendar year 2008 that consumes at least 20 percent but not more than 22.9 percent less kilowatt hours per year than the 2001 energy conservation standards,

2. $75 in the case of a refrigerator that is manufactured in calendar year 2008 or 2009 that consumes at least 23 percent but no more than 24.9 percent less kilowatt hours per year than the 2001 energy conservation standards,

3. $100 in the case of a refrigerator that is manufactured in calendar year 2008, 2009 or 2010 that consumes at least 25 percent but not more than 29.9 percent less kilowatt hours per year than the 2001 energy conservation standards, and

4. $200 in the case of a refrigerator manufactured in calendar year 2008, 2009 or 2010 that consumes at least 30 percent less energy than the 2001 energy conservation standards.

Appliances eligible for the credit include only those that exceed the average amount of production from the two prior calendar years for each category of appliance, rather than the present law three prior calendar years. Additionally, the special rule with respect to refrigerators is eliminated.

The aggregate credit amount allowed with respect to a taxpayer for all taxable years beginning after December 31, 2007 may not exceed $75 million, with the exception that the $200 refrigerator credit and the $250 clothes washer credit are not limited.

The term "modified energy factor" means the modified energy factor established by the Department of Energy for compliance with the Federal energy conservation standard.

The term "gallons per cycle" means, with respect to a dishwasher, the amount of water, expressed in gallons, required to complete a normal cycle of a dishwasher.

The term "water consumption factor" means, with respect to a clothes washer, the quotient of the total weighted per-cycle water consumption divided by the cubic foot (or liter) capacity of the clothes washer.

Effective Date

The provision applies to appliances produced after December 31, 2007.

6. Seven-year applicable recovery period for depreciation of qualified energy management devices (sec. 1546 of the bill and sec. 168 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.[98] The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[99] Assets included in class 49.14, describing assets used in the transmission and distribution of electricity for sale and related land improvements, are assigned a class life of 30 years and a recovery period of 20 years.

Explanation of Provision

The provision provides a seven-year recovery period for any qualified energy management device. For purposes of the provision, a qualified energy management device means any energy management device which: (1) is installed on real property of a customer of the taxpayer; and (2) is placed in service by a taxpayer who is a supplier of electric energy or a provider of electric energy services that provides all commercial and residential customers with net metering upon the customer's request. For purposes of the provision, net metering means allowing customers a credit for providing electricity to the supplier or provider.

An energy management device is any time-based meter and related communication equipment which is capable of being used by the taxpayer as part of a system that: (1) measures and records electricity usage data on a time-differentiated basis in at least 24 separate time segments per day; (2) provides for the exchange of information between the supplier or provider and the customer's energy management device in support of time-based rates or other forms of demand response; and (3) provides data to such supplier or provider so that the supplier or provider can provide energy usage information to customers electronically.

Effective Date

The provision is effective for property placed in service after December 31, 2007.

---

[98] Sec. 168.

[99] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

D. Other Provisions

1. Deduction for qualified timber gain and timber REIT provisions (secs. 1551-1556 of the bill and new sec. 1203 and secs. 856, 857, and 4981 of the Code)

Present Law

Treatment of certain timber gain

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. [100] For purposes of determining the gain attributable to such cutting, and the cost of the cut timber for purposes of the taxpayer's income from later sales of the timber or timber products, the fair market value of the timber on the first day of the taxable year in which the timber is cut is used. 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.[101] This treatment under either section 631(a) or (b) requires that the taxpayer has owned the timber or held the contract right for a period of more than one year.

Under present law, for taxable years beginning before January 1, 2011, the maximum rate of tax on long term capital gain ("net capital gain")[102] of an individual, estate, or trust is 15 percent. Any net capital gain that 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.[103]

For taxable years beginning after December 31, 2010, the maximum rate of tax on the net capital gain of an individual is 20 percent. Any net capital gain that otherwise would 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 is 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, is taxed at an 18-percent rate. The net

---

[100] Sec. 631(a).

[101] Sec. 631(b).

[102] Net capital gain is defined as the excess of net long-term capital gain over net short-term capital gain for the taxable year. Sec. 1222(11).

[103] 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.

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

Real estate investment trusts ("REITs") are subject to a special taxation regime. Under this regime, a REIT is allowed a deduction for dividends paid to its shareholders.[104] As a result, REITs generally do not pay tax on distributed income, but the income is taxed to the REIT shareholders. A REIT that has long-term capital gain can declare a dividend that shareholders are entitled to treat as long term capital gain.

REITs generally are required to distribute 90 percent of their taxable income (other than net capital gain). A REIT generally must pay tax at regular corporate rates on any undistributed income. However, a REIT that has net capital gain can retain that gain without distributing it, and the shareholders can report the net capital gain as if it were distributed to them. In that case the REIT pays a C corporation tax on the retained gain, but the shareholders who report the income are entitled to a credit or refund for the difference between the tax that would be due if the income had been distributed and the 35-percent rate paid by the REIT.[105] In effect, net capital gain of a REIT (including but not limited to timber gain) can be taxed as net capital gain of the shareholders, whether or not the gain is distributed.

Other REIT provisions

A REIT is also subject to a 4-percent excise tax to the extent it does not distribute specified percentages of its income within any calendar year. The required distributed percentage is 85 percent in the case of the REIT ordinary income, and 95 percent in the case of the REIT capital gain net income (as defined).[106] The amount of the excess of the required distribution over the actual distribution is subject to the 4-percent tax.

A REIT generally is restricted to earning certain types of passive income. Among other requirements, at least 75 percent of the gross income of a REIT in a taxable year must consist of certain types of real estate related income, including rents from real property, income from the sale or exchange of real property (including interests in real property) that is not stock in trade, inventory, or held by the taxpayer primarily for sale to customers in the ordinary course of its

[104] A distribution to a corporate shareholder out of current or accumulated earnings and profits of the corporation is a dividend, unless the distribution is a redemption that terminates the shareholder's stock interest or reduces the shareholder's interest in the distributing corporation to an extent considered to result in treatment as a sale or exchange of the shareholder's stock. Secs. 301 and 302. A distribution in excess of corporate earnings and profits is treated by shareholders as first a recovery of their stock basis and then, to the extent the distribution exceeds a shareholder's stock basis, as a sale or exhange of the stock. Sec. 301. These rules generally apply to REITs.

[105] Sec. 857(b)(3)(D). The shareholders also obtain a basis increase in their REIT stock for the gross amount of the deemed distribution that is included in their income less the amount of corporate tax deemed paid by them that was paid by the REIT on the retained gain. Sec. 857(b)(3)(D)(iii).

[106] Sec. 4981. The definition is the excess of gains from sales or exchanges of capital assets over losses from such sales or exchanges for the calendar year, reduced by any net ordinary loss.

trade or business, and interest on mortgages secured by real property or interests in real property.[107] Interests in real property are specifically defined to exclude mineral, oil, or gas royalty interests.[108] A REIT will not qualify as a REIT, and will be taxable as a C corporation, for any taxable year if it does not meet this income test.

Some REITs have been formed to hold land on which trees are grown. Upon maturity of the trees, the standing trees are sold by the REIT. The Internal Revenue Service has issued private letter rulings in particular instances stating that the income from the sale of the trees under section 631(b) can qualify as REIT real property income because the uncut timber and the timberland on which the timber grew is considered real property and the sale of uncut trees can qualify as capital gain derived from the sale of real property.[109]

A REIT is subject to a 100-percent excise tax on gain from any sale that is a "prohibited transaction," defined as a sale of property that is stock in trade, inventory, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.[110] This determination is based on facts and circumstances. However, a safe-harbor provides that no excise tax is imposed if certain requirements are met. In the case of timber property, the safe harbor is met, regardless of the number of sales that occur during the taxable year, if (i) the REIT has held the property for not less than 4 years in connection with the trade or business of producing timber; (ii) the aggregate adjusted bases of the property sold (other than foreclosure property) during the taxable year does not exceed 10 percent of the aggregate bases of all the assets of the REIT as of the beginning of the taxable year, and if certain other requirements are met. These include requirements that limit the amount of expenditures the REIT can make during the 4-year period prior to the sale that are includible in the adjusted basis of the property,[111] that require marketing to be done by an independent contractor, and that forbid a sales price that is based on the income or profits of any person.[112] There is a similar but separate safe harbor for

[107] Sec. 856(c) and 1221(a). Income from sales that are not prohibited transactions solely by virtue of section 857(b)(6) is also qualified REIT income.

[108] Sec. 856(c)(5)(C).

[109] Timber income under section 631(b) has also been held to be qualified real estate income even if the one year holding period is not met. *See, e.g.,* PLR 200052021 data, *see also* PLR 199945055 data, PLR 199927021 data, PLR 8838016 data. A private letter ruling may be relied upon only by the taxpayer to which the ruling is issued. However, such rulings provide an indication of administrative practice.

[110] Secs. 857(b)(6) and 1221(a)(1). There is an exception for certain foreclosure property.

[111] Aggregate expenditures (other than timberland acquisition expenditures) during such period made by the REIT or a partner of the REIT, which are includible in basis, may not exceed 30 percent of the net selling price in the case of expenditures that are directly related to operation of the property for the production of timber or the preservation of the property for use as timberland, and may not exceed 5 percent of the net selling price in the case of expenditures that are not directly related to those purposes.

[112] Sec. 857(b)(6)(D).

sales of non-timber property, with similar rules, including a 4-year holding period requirement and a limit on the percentage of the aggregate adjusted basis of property that can be sold in one taxable year.[113]

A REIT is not generally permitted to hold securities representing more than 10 percent of the voting power or value of the securities of any one issuer; nor may more than 5 percent of the fair market value of REIT assets be securities of any one issuer.[114] However, under an exception, a REIT may hold any amount of securities of one or more "taxable REIT subsidiary" ("TRS") corporations, provided that such TRS securities do not represent more than 20 percent of the fair market value of REIT assets at the end of any quarter. A TRS is a C corporation that is subject to regular corporate tax on its income and that meets certain other requirements. A taxable REIT subsidiary may conduct activities that would produce disqualified non-passive or non-real estate income that could disqualify the REIT if conducted by a REIT itself. Such business could include business relating to processing timber, or holding timber products or other assets for sale to customers in the ordinary course of business. Such income would be subject to regular corporate rates of tax as income of the TRS.[115]

Explanation of Provision

Elective deduction for 60 percent of qualified timber gain

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.[116]

---

[113] Sec. 857(b)(6)(C).

[114] Sec. 856(c)(4)(B)(ii) and (iii). Certain interests are not treated as "securities" for purposes of the rule forbidding the REIT to hold securities representing more than 10 percent of the value of securities of any one issuer. Sec. 856(m).

[115] A 100-percent excise tax is imposed on the amount of certain transactions involving a TRS and a REIT, to the extent such amount would exceed an arm's length amount under section 482. Sec. 857(b)(7).

[116] 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.

In the case of a pass-thru entity other than a REIT, 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.

In the case of a REIT, the election to take the 60-percent deduction is made by the REIT. If a REIT makes the election, then the timber gain is excluded from the computation of capital gain or loss of the REIT and can no longer be designated as a capital gain dividend to shareholders. Instead, the gain is treated as ordinary income for purposes of applying the REIT income distribution requirements, but for this purpose 60 percent of the amount of the gain is deductible by the REIT in computing its income. REIT earnings and profits also exclude the portion of the timber gain that is deductible. Thus, 40 percent of the gain is subject to the REIT distribution requirements,[117] and 40 percent of the gain increases REIT earnings and profits. Accordingly, because REIT earnings and profits have been increased by the 40-percent amount, there is sufficient earnings and profits that a distribution of that 40-percent amount that otherwise qualifies as a dividend would be treated as an ordinary dividend distribution to shareholders. Since this dividend is from a REIT and is not derived from an entity that was taxed as a C corporation, it would not qualify for the current 15 percent qualified dividend rates and would be taxed at the ordinary income rates of the shareholders.

REIT shareholders obtain an upward basis adjustment in their REIT interests, equal to the 60 percent of the timber gain that is deductible by the electing REIT. Because the 60 percent of timber gain that was deductible by the REIT does not increase REIT earnings and profits, a distribution of such 60 percent to the shareholder generally will not be treated as a dividend (in the absence of other retained earnings) but as a return of basis under the general rules of section 301(c). Because the shareholders' basis has been increased by this 60 percent, this distribution would not exceed the shareholders' basis and thus would be nontaxable return of basis, rather than capital gain in excess of basis. However, if a REIT shareholder has obtained such an upward basis adjustment for a REIT interest and disposes of the interest before having held the interest for at least 6 months, then any loss on disposition of the interest is disallowed to the extent of such upward basis adjustment.

Additional REIT provisions

Timber gain qualified REIT income without regard to one year holding period

The provision specifically includes timber gain under section 631(a) as a category of statutorily recognized qualified real estate income of a REIT if the cutting is provided by a taxable REIT subsidiary, and also includes gain recognized under section 631(b). For purposes of such qualified income treatment under those provisions, the requirement of a one-year holding period is removed. Thus, for a example, a REIT can acquire timber property and harvest the timber on the property within one year of the acquisition, with the resulting income being

[117] For purposes of the section 4981 excise tax on undistributed REIT income, the amount treated as subject to the 95-percent distribution requirement is the 40 percent of timber gain income that remains after allowing the deduction.

qualified real estate income for REIT qualification purposes, even though such income is not eligible for long term capital gain treatment under section 631(a) or (b). The provision specifically provides, however, that for all purposes of the Code, such income shall not be considered to be gain described in section 1221(a)(1), that is, it shall not be treated as income from the sale of stock in trade, inventory, or property held by the REIT primarily for sale to customers in the ordinary course of the REITs trade or business.

For purposes of determining REIT income, if the cutting is done by a taxable REIT subsidiary, the cut timber is deemed sold on the first day of the taxable year to the taxable REIT subsidiary (with subsequent gain, if any, attributable to the taxable REIT subsidiary).

REIT prohibited transaction safe harbor for timber property

For sales to a qualified organization for conservation purposes, as defined in section 170(h), the provision reduces to two years the present law four-year holding period requirement under section 857(b)(6)(D), which provides a safe harbor from "prohibited transaction" treatment for certain timber property sales. Also, in the case of such sales, the safe-harbor limitations on how much may be added, within the four-year period prior to the date of sale, to the aggregate adjusted basis of the property, are changed to refer to the two-year period prior to the date of sale.

The provision also removes the safe-harbor requirement that marketing of the property must be done by an independent contractor, and permits a taxable REIT subsidiary of the REIT to perform the marketing.

The provision states that any gain that is eligible for the timber property safe harbor is considered for all purposes of the Code not to be described in section 1221(a)(1), that is, it shall not be treated as income from the sale of stock in trade, inventory, or property held by the REIT primarily for sale to customers in the ordinary course of the REITs trade or business.

Special rules for Timber REITs

The provision contains several provisions applicable only to a "timber REIT," defined as a REIT in which more than 50 percent of the value of its total assets consists of real property held in connection with the trade or business of producing timber.

First, mineral royalty income from real property owned by a timber REIT and held, or once held, in connection with the trade or business of producing timber by such REIT, is included as qualifying real estate income for purposes of the REIT income tests.

Second, a timber REIT is permitted to hold TRS securities with a value up to 25 percent, (rather than 20 percent) of the value of the total assets of the REIT.

Effective Date

The provision applies to taxable years beginning after the date of enactment, but does not apply after the last day of the first taxable year beginning after the date of enactment.

2. Treatment of amounts received in connection with the Exxon Valdez litigation (sec. 1557 of the bill)

Present Law

Income averaging

Section 1301 provides special income averaging rules for individuals engaged in a farming business or fishing business. Under section 1301, such an individual may elect to average the taxable income attributable to the farming or fishing business over a 3-year period.

Contributions to qualified retirement plans and IRAs

The Code provides for the favorable tax treatment of a variety of retirement savings plans sponsored by employers for the benefit of employees, provided that such plans meet certain qualification requirements. Such plans are commonly referred to as "qualified retirement plans." Qualified retirement plans include the following types of plans: (1) plans qualified under section 401(a) (such as a "section 401(k) plan"); (2) section 403(a) employee retirement annuities; (3) tax-sheltered annuities (described in section 403(b)); and (4) section 457(b) plans sponsored by State and local governments.

One of the qualification requirements that apply to qualified retirement plans is limits on the amount of contributions that may be made to such a plan. For example, in the case of a defined contribution plan, the annual additions that can be made to a participant's account balance is limited to the lesser of 100 percent of the participant's compensation or $45,000 (for 2007). Elective salary reduction deferrals by a participant in a section 401(k) plan, a tax-sheltered annuity, or a section 457(b) plan maintained by a State or local government are subject to a separate annual limitation. The limitation on the amount of annual elective deferrals is generally $15,500 (for 2007), although participants who have attained age 50 may be eligible to make an additional $5,000 (for 2007) in elective deferrals. In general, a distribution from a qualified retirement plan is includible in a participant's gross income except to the extent the distribution is attributable to employee after-tax contributions to the plan.

The Code also provides for two types of individual retirement arrangements ("IRAs"): traditional IRAs and Roth IRAs.[118] In general, contributions (other than a rollover contribution) to a traditional IRA may be deductible, and distributions from a traditional IRA are includible in gross income to the extent not attributable to a return of nondeductible contributions. In contrast, contributions to a Roth IRA are not deductible, and qualified distributions from a Roth IRA are excludable from gross income. Distributions from a Roth IRA that are not qualified distributions are includible in gross income to the extent attributable to earnings. In general, a qualified distribution is a distribution that is made on or after the individual attains age 59-½, death, or disability or which is a qualified special purpose distribution.

---

[118] Traditional IRAs are described in Code section 408, and Roth IRAs are described in Code section 408A.

The total amount that an individual may contribute to one or more IRAs for a year is generally limited to the lesser of: (1) a dollar amount ($4,000 for 2007); or (2) the amount of the individual's compensation that is includible in gross income for the year. As under the rules relating to traditional IRAs, a contribution of up to the dollar limit for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with adjusted gross income for the taxable year over certain indexed levels. The adjusted gross income phase-out ranges for 2007 are: (1) for single taxpayers, $99,000 to $114,000; (2) for married taxpayers filing joint returns, $156,000 to $166,000; and (3) for married taxpayers filing separate returns, $0 to $10,000.

For taxable years beginning after December 31, 2005, a plan qualified under section 401(a) or a section 403(b) annuity is permitted to include a qualified Roth contribution program. Under such a program a participant can designate elective salary deferrals as designated Roth contributions. A designated Roth contribution is includible in the participant's gross income at the time of deferral and is generally excludable from gross income at the time of distribution.

The foregoing contribution limitations for qualified retirement plans and IRAs do not apply in the case of a rollover contribution to a qualified retirement plan or IRA. If certain requirements are satisfied, a participant in a tax-qualified retirement plan, a tax-sheltered annuity, a governmental section 457 plan, or a traditional IRA may roll over distributions from the plan, annuity or IRA into another plan, annuity or IRA. For distributions after December 31, 2007, certain taxpayers also are permitted to make rollover contributions into a Roth IRA (subject to inclusion in gross income of any amount that would be includible were it not part of the rollover contribution).

Explanation of Provision

Income averaging

Under the provision, any qualified taxpayer receiving qualified settlement income in any taxable year shall be treated as if engaged in a fishing business, and the qualified settlement income shall be treated as income attributable to a fishing business for the taxable year for purposes of applying the income averaging rules applicable to farming and fishing income under section 1301. The portion of a taxpayer's taxable income that he or she may elect to be treated as "elected farm income" eligible for income averaging under this provision is the amount of qualified settlement income reduced by the otherwise allowable deductions attributable to that income. Nothing in this provision changes the computation of taxable income or alternative minimum taxable income.

Contributions to retirement plans

Under the provision, a qualified taxpayer who receives qualified settlement income during a taxable year may, at any time before the end of such year, make one or more contributions to an eligible retirement plan. The amount that can be contributed under the provision (in aggregate for all taxable years) is the lesser of (1) the amount of qualified settlement income or (2) $100,000. If such a contribution is made, the contribution is excludible from the qualified taxpayer's gross income (unless the contribution is made to a Roth IRA or to a designated Roth account established under a qualified Roth contribution program) and is treated as a rollover contribution to the eligible retirement plan. Under the provision, an eligible retirement plan includes an IRA (traditional or Roth), a section 401(a) plan, a section 403(a) employee retirement annuity, a tax-sheltered annuity, and a section 457(b) plan maintained by a State or local government.

Qualified taxpayer; qualified settlement income

Under the provision, the term a "qualified taxpayer" means any individual who is a plaintiff in the civil action *In re Exxon Valdez*, No. 89-095-CV (HRH) (Consolidated) (D. Alaska) or any individual who is a beneficiary of the estate of such a plaintiff who acquired the right to receive qualified settlement income from the plaintiff and who was the spouse or immediate relative of that plaintiff. "Qualified settlement income" means any interest and punitive damage awards which are includible in taxable income[119] and are received in connection with the before-described civil action, whether pre- or post-judgment and whether related to a settlement or judgment.

Effective Date

The provision is effective upon the date of enactment.

[119] This rule is applied without regard to the retirement plan contribution rule previously discussed.

E. Revenue Raising Provisions

1. Denial of deduction for income attributable to domestic production of oil, gas, or primary products thereof (sec. 1561 of the bill and sec. 199 of the Code)

Present Law

In general

Section 199 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 (or taxable income, if less). 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. However, the deduction for a taxable year is limited to 50 percent of the wages properly allocable to domestic production gross receipts paid by the taxpayer during the calendar year that ends in such taxable year.[120]

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 that 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 property ("QPP") that was manufactured, produced, grown or extracted ("MPGE") by the taxpayer in whole or in significant part within the United States;[121] (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film 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

[120] 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. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and, for taxable years beginning after December 31, 2005, designated Roth contributions (as defined in section 402A).

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

United States;[122] or (5) engineering or architectural services performed in the United States for construction projects located in the United States.

Congress granted Treasury broad authority to "prescribe such regulations as are necessary to carry out the purposes" of section 199.[123] In defining MPGE for purposes of section 199, Treasury described the following as MPGE activities: manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP; making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; cultivating soil, raising livestock, fishing, and mining minerals.[124]

The regulations specifically cite an example of oil refining activities in describing the "in whole or in significant part" test in determining domestic production gross receipts. QPP is generally considered to be MPGE in significant part by the taxpayer within the United States if such activities are substantial in nature taking into account all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer's MPGE activity within the United States, the nature of the QPP, and the nature of the MPGE activity that the taxpayer performs within the United States.[125] The following example is provided in the regulations to illustrate this "substantial in nature" standard:

> X purchases from Y, an unrelated person, unrefined oil extracted outside the United States. X refines the oil in the United States. The refining of the oil by X is an MPGE activity that is substantial in nature.[126]

Electricity or natural gas transmission or distribution

Although domestic production gross receipts include the gross receipts from the production in the United States of electricity and gas, the provision excludes gross receipts from the transmission or distribution of electricity and gas. Thus, in the case of a taxpayer who owns a facility for the production of electricity (either as part of a regulated utility or an independent power facility), the taxpayer's gross receipts from the production of electricity at that facility are qualified domestic production gross receipts. However, to the extent that the taxpayer is an integrated producer that generates electricity and delivers electricity to end users, any gross

---

[122] For this purpose, construction activities include activities that are directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure. Substantial renovation would include structural improvements, but not mere cosmetic changes, such as painting, that is not performed in connection with activities that otherwise constitute substantial renovation.

[123] Sec. 199(d)(9).

[124] Treas. Reg. sec. 1.199-3(e)(1).

[125] Treas. Reg. sec. 1.199-3(g)(2).

[126] Treas. Reg. sec. 1.199-3(g)(5), Example 1.

receipts properly attributable to the transmission of electricity from the generating facility to a point of local distribution and any gross receipts properly attributable to the distribution of electricity to final customers are not qualified domestic production gross receipts.

For example, taxpayer A owns a wind turbine that generates electricity and taxpayer B owns a high-voltage transmission line that passes near taxpayer A's wind turbine and ends near the system of local distribution lines of taxpayer C.[127] Taxpayer A sells the electricity produced at the wind turbine to taxpayer C and contracts with taxpayer B to transmit the electricity produced at the wind turbine to taxpayer C who sells the electricity to his or her customers using taxpayer C's distribution network. The gross receipts received by taxpayer A for the sale of electricity produced at the wind turbine constitute qualifying domestic production gross receipts. The gross receipts of taxpayer B from transporting taxpayer A's electricity to taxpayer C are not qualifying domestic production gross receipts. Likewise, the gross receipts of taxpayer C from distributing the electricity are not qualifying domestic production gross receipts. Also, if taxpayer A made direct sales of electricity to customers in taxpayer C's service area and taxpayer C received remuneration for the distribution of electricity, the gross receipts of taxpayer C are not qualifying domestic production gross receipts. If taxpayers A, B, and C are all related taxpayers, then taxpayers A, B, and C must allocate gross receipts to production activities, transmission activities, and distribution activities in a manner consistent with the preceding example.

The same principles apply in the case of the natural gas industry. In the case of natural gas, production activities generally are all activities involved in extracting natural gas from the ground and processing the gas into pipeline quality gas. Such activities would produce qualifying domestic production gross receipts. However, gross receipts of a taxpayer attributable to transmission of pipeline quality gas from a natural gas field (or from a natural gas processing plant) to a local distribution company's citygate (or to another customer) are not qualified domestic production gross receipts. Likewise, gas purchased by a local gas distribution company and distributed from the citygate to the local customers does not give rise to domestic production gross receipts.[128]

<u>Drilling oil or gas wells</u>

The Treasury regulations provide that qualifying construction activities performed in the United States include activities relating to drilling an oil or gas well.[129] Under the regulations, activities the cost of which are intangible drilling and development costs within the meaning of

[127] H.R. Rep. No. 108-755 (conference report for the American Jobs Creation Act of 2004), 272 n 28.

[128] Id.

[129] Treas. Reg. sec. 1.199-3(m)(1)(i).

Treas. Reg. sec. 1.612-4 are considered to be activities constituting construction for purposes of determining domestic production gross receipts.[130]

Qualifying in-kind partnerships

In general, an owner of a pass-thru entity is not treated as conducting the qualified production activities of the pass-thru entity, and vice versa. However, the Treasury regulations provide a special rule for "qualifying in-kind partnerships," which are defined as partnerships engaged solely in the extraction, refining, or processing of oil, natural gas, petrochemicals, or products derived from oil, natural gas, or petrochemicals in whole or in significant part within the United States, or the production or generation of electricity in the United States.[131] In the case of a qualifying in-kind partnership, each partner is treated as MPGE or producing the property MPGE or produced by the partnership that is distributed to that partner.[132] If a partner of a qualifying in-kind partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of the property that was MPGE or produced by the qualifying in-kind partnership, then, provided such partner is a partner of the qualifying in-kind partnership at the time the partner disposes of the property, the partner is treated as conducting the MPGE or production activities previously conducted by the qualifying in-kind partnership with respect to that property.[133]

Alternative minimum tax

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

Explanation of Provision

The provision excludes gross receipts of major integrated oil companies derived from the sale, exchange, or other disposition of oil, gas, or any primary product thereof from the term "domestic production gross receipts" for purposes of section 199. For taxpayers other than major integrated oil companies, the provision reduces to six percent the percentage used to calculate the deduction associated with oil related qualified production activities income for taxable years beginning after 2009.

---

[130] Treas. Reg. sec. 1.199-3(m)(2)(iii).

[131] Treas. Reg. sec. 1.199-9(i)(2).

[132] Treas. Reg. sec. 1.199-9(i)(1).

[133] Id.

A major integrated oil company, as defined in section 167(h)(5)(B), is an integrated oil company[134] that has an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year, had gross receipts in excess of one billion dollars for its last taxable year ending during the calendar year 2005, and generally has an ownership interest in a crude oil refiner of 15 percent or more.

The term "primary product" has the same meaning as when used in section 927(a)(2)(C), as in effect before its repeal. The Treasury regulations define the term "primary product from oil" to mean crude oil and all products derived from the destructive distillation of crude oil, including volatile products, light oils such as motor fuel and kerosene, distillates such as naphtha, lubricating oils, greases and waxes, and residues such as fuel oil.[135] Additionally, a product or commodity derived from shale oil which would be a primary product from oil if derived from crude oil is considered a primary product from oil.[136] The term "primary product from gas" is defined as all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including natural gas, condensates, liquefied petroleum gases such as ethane, propane, and butane, and liquid products such as natural gasoline.[137] These primary products and processes are not intended to represent either the only primary products from oil or gas, or the only processes from which primary products may be derived under existing and future technologies.[138] Examples of non-primary products include, but are not limited to, petrochemicals, medicinal products, insecticides, and alcohols.[139]

For a taxpayer, other than a major integrated oil company, with oil related qualified production activities income for any taxable year beginning after 2009, the amount of the deduction is reduced by three percent of the lesser of: (1) the oil related qualified production activities income of the taxpayer for the taxable year; (2) the qualified production activities income of the taxpayer for the taxable year; or (3) taxable income (before the deduction under section 199). For these purposes, oil related qualified production activities income includes the qualified production activities income which is attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof.

---

[134] Generally, an integrated oil company is a producer of crude oil that engages in the refining or retail sale of petroleum products in excess of certain threshold amounts.

[135] Treas. Reg. sec. 1.927(a)-1T(g)(2)(i).

[136] Id.

[137] Treas. Reg. sec. 1.927(a)-1T(g)(2)(ii).

[138] Treas. Reg. sec. 1.927(a)-1T(g)(2)(iii).

[139] Treas. Reg. sec. 1.927(a)-1T(g)(2)(iv).

Effective Date

The provision is effective for taxable years beginning after December 31, 2007.

2. Eliminate the distinction between FOGEI and FORI and apply present-law FOGEI rules to all foreign income from the production and sale of oil and gas product (sec. 1562 of the bill and sec. 907 of the Code)

Present Law

In general

Foreign tax credit

The United States taxes its citizens and residents (including U.S. corporations) on their worldwide income. Because the countries in which income is earned also may assert their jurisdiction to tax the same income on the basis of source, foreign-source income earned by U.S. persons may be subject to double taxation. In order to mitigate this possibility, the United States generally provides a credit against U.S. tax liability for foreign income taxes paid or accrued.[140] In the case of foreign income taxes paid or accrued by a foreign subsidiary, a U.S. parent corporation is generally entitled to an indirect (also referred to as a deemed paid) credit for those taxes when it receives an actual or deemed distribution of the underlying earnings from the foreign subsidiary.[141]

Foreign tax credit limitations

The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source income. This general limitation is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.[142]

In addition, this limitation is calculated separately for various categories of income, generally referred to as "separate limitation categories." The total amount of the foreign tax credit used to offset the U.S. tax on income in each separate limitation category may not exceed the proportion of the taxpayer's U.S. tax which the taxpayer's foreign-source taxable income in that category bears to its worldwide taxable income in that category. The separate limitation rules are intended to reduce the extent to which excess foreign taxes paid in a high-tax foreign

---

[140] Sec. 901.

[141] Secs. 902, 960.

[142] Sec. 904(a).

jurisdiction can be "cross-credited" against the residual U.S. tax on low-taxed foreign-source income.[143]

Special limitation on credits for foreign extraction taxes and taxes on foreign oil related income

In addition to the foreign tax credit limitations that apply to all foreign tax credits, a special limitation is placed on foreign income taxes on foreign oil and gas extraction income ("FOGEI").[144] Under this special limitation, amounts claimed as taxes paid on FOGEI of a U.S. corporation qualify as creditable taxes (if they otherwise so qualify) only to the extent they do not exceed the product of the highest marginal U.S. tax rate on corporations (presently 35 percent) multiplied by such extraction income. Foreign taxes paid in excess of that amount on such income are, in general, neither creditable nor deductible. The amount of any such taxes paid or accrued (or deemed paid) in any taxable year which exceeds the FOGEI limitation may be carried back to the immediately preceding taxable year and carried forward 10 taxable years and credited (not deducted) to the extent that the taxpayer otherwise has excess FOGEI limitation for those years.[145]

A similar special limitation applies, in theory, to foreign taxes paid on foreign oil related income ("FORI") in certain cases where the foreign law imposing such amount of tax is structured, or in fact operates, so that the amount of tax imposed with respect to foreign oil related income will generally be "materially greater," over a "reasonable period of time," than the amount generally imposed on income that is neither FORI nor FOGEI.[146] Under the FORI rules, if this theoretical limitation were to apply, then the portion of the foreign taxes on FORI so disallowed would be recharacterized as a (non-creditable) deductible expense.[147]

As a general matter, the FOGEI and FORI rules of section 907 are informed by two related but distinct concerns. First, as described by the Staff of the Joint Committee on Taxation in 1982, the rules were designed to address the perceived problem of "disguised royalties" being improperly treated as creditable foreign taxes:

---

[143] Sec. 904(d). For taxable years beginning prior to January 1, 2007, section 904(d) provides eight separate baskets as a general matter, and effectively many more in situations in which various special rules apply. The American Jobs Creation Act of 2004 reduced the number of baskets from nine to eight for taxable years beginning after December 31, 2002, and further reduced the number of baskets to two (i.e., "general" and "passive") for taxable years beginning after December 31, 2006. Pub. L. No. 108-357, sec. 404 (2004).

[144] Sec. 907(a).

[145] Sec. 907(f). These carryback and carryforward rules are similar to the general foreign tax credit carryback and carryforward rules of section 904(c).

[146] Sec. 907(b).

[147] Treas. Reg. sec. 1.907(a)-0(d).

> When U.S. oil companies began operations in a number of major oil exporting countries, they paid only a royalty for the oil extracted since there was generally no applicable income tax in those countries. However, in part because of the benefit to the oil companies of imposing an income tax, as opposed to a royalty, those countries have adopted taxes applicable to extraction income and have labeled them income taxes. Moreover, because of this relative advantage to the oil companies of paying income taxes rather than royalties, many oil-producing nations in the post-World II era have tended to increase their revenues from oil extraction by increasing their taxes on U.S. oil companies.[148]

In addition, the section 907 rules have also been described as intended to prevent the crediting of high foreign taxes on FOGEI and FORI against the residual U.S. tax on other types of lower-taxed foreign source income.[149] Consistent with this concern, between 1975 and 1982 the foreign tax credit rules provided a separate limitation category (or "basket") under the general section 904 limitation for foreign oil income (broadly defined to include both FORI and FOGEI within the meaning of present law section 907); this separate basket for foreign oil income was eliminated when the present law FORI rules were added and other changes were made by the Tax Equity and Reform Act of 1982.[150]

Determination of FOGEI and FORI

In general

Determination of a taxpayer's FOGEI and FORI is highly specific to the taxpayer's relevant facts and circumstances. Under section 907(c)(1), FOGEI is defined as taxable income derived from sources outside the United States and its possessions from the extraction (by the taxpayer or any other person) of minerals from oil or gas wells located outside the United States and its possessions or from the sale or exchange of assets used by the taxpayer in the trade or business of extracting those minerals.[151] The regulations provide that "gross income from extraction is determined by reference to the fair market value of the minerals in the immediate vicinity of the well."[152]

---

[148] Joint Committee on Taxation, *Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (JCS-38-82), Dec. 31, 1982, sec. IV.A.7.a, footnote 63.

[149] H.R. Conf. Rep. No. 103-213, at 646 (1993).

[150] Pub. L. No. 97-248, sec. 211(c) (1982).

[151] Sec. 907(c)(1).

[152] Treas. Reg. sec. 1.907(c)-1(b)(2).

The regulations do not provide specific methods for determining the fair market value of the extracted oil or gas in the immediate vicinity of the well, but simply provide that all the facts and circumstances that exist in the particular case must be considered, including (but not limited to) facts and circumstances pertaining to the independent market value (if any) in the immediate vicinity of the well, the fair market value at the port of the foreign county, and the relationships between the taxpayer and the foreign government.[153]

Section 907(c)(2) defines FORI to include taxable income from the processing of oil and gas into their primary products, from the transportation or distribution and sale of oil and gas and their primary products, from the disposition of assets used in these activities, and from the performance of any other related service.[154]

As a result of these separate rules governing FOGEI and FORI and the interaction between them, a taxpayer's determination of the amounts of FOGEI and FORI, as well as the allocation of foreign taxes to each class of income, can have a significant impact on the taxpayer's overall U.S. tax liability.

IRS field directive

An October 12, 2004, IRS field directive (the "2004 Field Directive") sets forth guidance to international examiners and specialists on the application of what it describes as the two most commonly used methods for determining FOGEI and FORI when there is no ascertainable market price for the oil and gas in the immediate vicinity of the well, namely the residual (rate of return) method and the proportionate profits method.[155]

Under the residual (rate of return) method, the taxpayer first calculates FORI by applying an assumed after-tax rate of return to the cost of its fixed "FORI assets." Then, because income from the production and sale of oil and gas product is equal to the sum of FORI and FOGEI, FOGEI is determined by subtracting FORI (as calculated) from the taxpayer's total foreign income from the production and sale of oil and gas product.

Under the proportionate profits method, the taxpayer allocates total income from the production and sale of the oil or gas product between FOGEI and FORI based on the relative costs of the FOGEI and FORI activities.

---

[153] Treas. Reg. sec. 1.907(c)-1(b)(6).

[154] Sec. 907(c)(1); Treas. Reg. sec. 1.907(c)-1(d).

[155] Memorandum for Industry Directors ("Field Directive on IRC §907 Evaluating Taxpayer Methods of Determining Foreign Oil and Gas Extraction Income (FOGEI) and Foreign Oil Related Income (FORI)"), October 12, 2004 (Tax Analysts Doc 2004-23010; 2004 TNT 233-8). By its terms, the 2004 Field Directive "is not an official pronouncement of the law or the Service's position and cannot be used, cited, or relied upon as such."

Under either method, the taxpayer must determine its total income from the production and sale of oil and gas product, and must distinguish between costs and assets classified as relating to FOGEI and those relating to FORI. Under the residual (rate of return) method, the taxpayer must also determine appropriate rates of return for FORI assets. The 2004 Field Directive sets forth examples of FOGEI assets[156] and FORI assets,[157] and further provides that assets that support both FOGEI and FORI may be allocated by any reasonable method.

Explanation of Provision

Under the provision, the scope of the present-law FOGEI rules is expanded to apply to all foreign income from production and other activity related to the sale of oil and gas product (i.e., the sum of FORI and FOGEI as classified under present law). Thus, amounts claimed as taxes paid on the amount of such (combined) foreign oil and gas income are creditable in a given taxable year (if they otherwise so qualify) only to the extent they do not exceed the product of the highest marginal U.S. tax rate on corporations multiplied by such combined foreign oil and gas income for such taxable year. As under the present-law FOGEI rules, excess foreign taxes may be carried back to the immediately preceding taxable year and carried forward 10 taxable years and credited (not deducted) to the extent that the taxpayer otherwise has excess limitation with regard to combined foreign oil and gas income in a carryover year. Under a transition rule, pre-2008 credits carried forward to post-2007 years will continue to governed by present law for purposes of determining the amount of carryforward credits eligible to be claimed in a post-2007 year; similarly, solely for purposes of determining whether excess credits generated in 2008 and carried back can be claimed to offset 2007 tax liability, the new rules will be deemed to apply in determining overall (combined FOGEI-FORI) limitation for the carryback year.

The provision repeals the present-law section 907(b) FORI limitation.

Effective Date

The provision is effective for taxable years beginning after December 31, 2007.

---

[156] Examples of FOGEI assets include wells, wellheads, and pumping equipment; slug catchers, separators, treaters, emulsion breakers and stock tanks needed to obtain marketable crude (for oil production); primary separation and dehydration equipment needed to arrive at a gaseous stream in which hydrocarbons may be recovered (for gas production); lines interconnecting the above; the infrastructure-type equipment to provide for the operation of the above; and structures to physically support the above (such as offshore platforms).

[157] Examples of FORI assets include lines that carry natural gas beyond the primary separator and dehydration equipment and towards its sales point, and compressors needed to transport through these lines; lines that carry marketable crude oil from the premises, as well as pumps needed to transport crude oil through these lines; and assets used to process crude oil and natural gas.

3. Seven-year amortization of geological and geophysical expenditures for major integrated oil companies (sec. 1563 of the bill and sec. 167(h) of the Code)

Present Law

Geological and geophysical expenditures ("G&G costs") 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. G&G costs incurred by independent producers and smaller integrated oil[158] companies in connection with oil and gas exploration in the United States may generally be amortized over two years.[159] Major integrated oil companies are required to amortize all G&G costs over five years.[160] For purposes of this proposal, a major integrated oil company, with respect to any taxable year, is a producer of crude oil which has an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year, had gross receipts in excess of one billion dollars for its last taxable year ending during the calendar year 2005, and generally has an ownership interest in a crude oil refiner of 15 percent or more.[161]

In the case of abandoned property, remaining basis may not be recovered in the year of abandonment of a property as all basis is recovered over the applicable amortization period.

Explanation of Provision

The provision extends from five years to seven years the amortization period for G&G costs for major integrated oil companies.

Effective Date

The provision is effective for amounts paid or incurred after the date of enactment.

---

[158] Generally, an integrated oil company is a producer of crude oil that engages in the refining or retail sale of petroleum products in excess of certain threshold amounts.

[159] Sec. 167(h)(1).

[160] Sec. 167(h)(5).

[161] Id.

4. Broker reporting of customer's basis in securities transactions (sec. 1564 of the bill and sec. 6045 and new secs. 6045A and 6045B of the Code)

Present Law

In general

Gain or loss generally is recognized for Federal income tax purposes on realization of that gain or loss (for example, through the sale of property giving rise to the gain or loss). The taxpayer's gain or loss on a disposition of property is the difference between the amount realized and the adjusted basis.[162]

To compute adjusted basis, a taxpayer must first determine the property's unadjusted or original basis and then make adjustments prescribed by the Code.[163] The original basis of property is its cost, except as otherwise prescribed by the Code (for example, in the case of property acquired by gift or bequest or in a tax-free exchange). Once determined, the taxpayer's original basis generally is adjusted downward to take account of depreciation or amortization, and generally is adjusted upward to reflect income and gain inclusions or capital outlays with respect to the property.

Basis computation rules

If a taxpayer has acquired stock in a corporation on different dates or at different prices and sells or transfers some of the shares of that stock, and the lot from which the stock is sold or transferred is not adequately identified, the shares deemed sold are the earliest acquired shares (the "first-in-first-out rule").[164] If a taxpayer makes an adequate identification of shares of stock that it sells, the shares of stock treated as sold are the shares that have been identified.[165] A taxpayer who owns shares in a regulated investment company ("RIC") generally is permitted to elect, in lieu of the specific identification or first-in-first-out methods, to determine the basis of RIC shares sold under one of two average-cost-basis methods described in Treasury regulations.[166]

Information reporting

Present law imposes information reporting requirements on participants in certain transactions. Under these requirements, information is generally reported to the IRS and furnished to taxpayers. These requirements are intended to assist taxpayers in preparing their

---

[162] Sec. 1001.

[163] Sec. 1016.

[164] Treas. Reg. sec. 1.1012-1(c)(1).

[165] Treas. Reg. sec. 1.1012-1(c).

[166] Treas. Reg. sec. 1.1012-1(e).

income tax returns and to help the IRS determine whether taxpayers' tax returns are correct and complete. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of $600 or more made in the course of the payor's trade or business.[167]

Section 6045(a) requires brokers to file with the IRS annual information returns showing the gross proceeds realized by customers from various sale transactions. The Secretary is authorized to require brokers to report additional information related to customers.[168] Brokers are required to furnish to every customer information statements with the same gross proceeds information that is included in the returns filed with the IRS for that customer.[169] These information statements are required to be furnished by January 31 of the year following the calendar year for which the return under section 6045(a) is required to be filed.[170]

A person who is required to file information returns but who fails to do so by the due date for the returns, includes on the returns incorrect information, or files incomplete returns generally is subject to a penalty of $50 for each return with respect to which such a failure occurs, up to a maximum of $250,000 in any calendar year.[171] Similar penalties, with a $100,000 calendar year maximum, apply to failures to furnish correct information statements to recipients of payments for which information reporting is required.[172]

Present law does not require information reporting with respect to a taxpayer's basis in property but does impose an obligation to keep records, as described below.

Basis recordkeeping requirements

Taxpayers are required to "keep such records . . . as the Secretary may from time to time prescribe."[173] Treasury regulations impose recordkeeping requirements on any person required to file information returns.[174]

Treasury regulations provide that donors and donees should keep records that are relevant in determining a donee's basis in property.[175] IRS Publication 552 states that a taxpayer should

[167] Sec. 6041(a).

[168] Sec. 6045(a).

[169] Sec. 6045(b).

[170] Id.

[171] Sec. 6721.

[172] Sec. 6722.

[173] Sec. 6001.

[174] Treas. Reg. sec. 1.6001-1(a).

keep basis records for property until the period of limitations expires for the year in which the taxpayer disposes of the property.

Explanation of Provision

In general

Under the provision, every broker that is required to file a return under section 6045(a) reporting the gross proceeds from the sale of a covered security must include in the return the (1) customer's adjusted basis in the security and (2) whether any gain or loss with respect to the security is long-term or short-term (within the meaning of section 1222).

Covered securities

A covered security is any specified security acquired on or after an applicable date if the security was (1) acquired through a transaction in the account in which the security is held or (2) was transferred to that account from an account in which the security was a covered security, but only if the transferee broker received a statement under section 6045A (described below) with respect to the transfer. Under this rule, securities acquired by gift or inheritance are not covered securities.

A specified security is any share of stock in a corporation (including stock of a regulated investment company); any note, bond, debenture, or other evidence of indebtedness; any commodity or a contract or a derivative with respect to the commodity if the Secretary determines that adjusted basis reporting is appropriate; and any other financial instrument with respect to which the Secretary determines that adjusted basis reporting is appropriate.

For stock in a corporation (including in a regulated investment company), the applicable date generally is January 1, 2009. Open-end funds (defined below) are permitted to elect to treat as a covered security any stock in the fund acquired before January 1, 2009. This election is described below.

For any specified security other than stock in a corporation, the applicable date is January 1, 2011, or a later date determined by the Secretary.

Computation of adjusted basis

The customer's adjusted basis required to be reported to the IRS is determined under the following rules. The adjusted basis of stock in a corporation other than an open-end fund is determined under the first-in, first-out method (described in Treasury regulations under section 1012) unless the customer notifies the broker by means of making an adequate identification (under the rules of section 1012 for specific identification) of the stock sold or transferred. The adjusted basis of stock in an open-end fund acquired before January 1, 2011 is determined in accordance with any acceptable method under section 1012 (that is, the first-in, first-out method,

[175] Treas. Reg. sec. 1.1015-1(g).

the average cost method, or the specific identification method). A broker's basis computation method used for open-end stock held in one account with that broker may differ from the basis computation method used for open-end stock held in another account with that broker. The adjusted basis of stock in an open-end fund acquired on or after January 1, 2011 is determined in accordance with the broker's default method (that is, a method that is permitted by section 1012 and that is generally used by the broker in tracking basis) unless the customer notifies the broker that the customer elects another method permitted by section 1012. This notification is made separately for each account in which open-end stock is held and, once made, applies to all open-end stock held in the account. The adjusted basis of any covered security other than stock is determined under the applicable rules provided in section 1012.

An open-end fund is a regulated investment company (as defined in section 851) that offers for sale or has outstanding any redeemable security of which it is the issuer and the shares of which are not traded on an established securities exchange. A mutual fund the stock of which is priced daily and is acquired from the fund is an open-end fund. So-called exchange traded funds, funds in which there is intra-day pricing and in which shares may be purchased on an exchange (rather than from the funds directly) are not open-end funds. It is intended that if a regulated investment company offers two or more classes of shares one or more of which is traded on an established securities exchange and one or more of which is not traded on such an exchange, the regulated investment company will be treated as an open-end fund with respect to the class or classes of shares that are not traded on an established securities exchange.

For any sale, exchange, or other disposition of a specified security after the applicable date (defined previously), the provision modifies section 1012 so that the conventions prescribed by regulations under that section for determining adjusted basis (the first-in, first-out, specific identification, and average cost conventions) apply on an account-by-account basis. Under this rule, for example, if a customer holds shares of the same specified security in accounts with different brokers, each broker makes its adjusted basis determinations by reference only to the shares held in the account with that broker. Unless the election described next applies, stock in an open-end fund acquired before January 1, 2009 is treated as a separate account. A consequence of this rule is that if adjusted basis is being determined using the average cost convention, average cost is computed without regard to any open-end stock acquired before January 1, 2009. An open-end fund, however, may elect (at the time and in the form and manner prescribed by the Secretary), on a stockholder-by-stockholder basis, to treat as covered securities all stock in the fund held by the stockholder without regard to when the stock was acquired. When this election applies, the average cost of a customer's open-end stock is determined by taking into account shares of stock acquired before, on, and after January 1, 2009. A similar election is allowed for any broker holding stock in an open-end fund as a nominee of the beneficial owner of the stock.

Exception for wash sales

Unless the Secretary provides otherwise, a customer's adjusted basis in a covered security generally is determined without taking into account the effect on basis of the wash sale rules of section 1091. If, however, the acquisition and sale transactions resulting in a wash sale under section 1091 occur in the same account and are in identical securities, adjusted basis is determined by taking into account the effect of the wash sale rules. Securities are identical for this purpose only if they have the same Committee on Uniform Security Identification Procedures number.

Special rules for short sales

The provision provides that in the case of a short sale, gross proceeds and basis reporting under section 6045 generally is required in the year in which the short sale is closed (rather than, as under the present law rule for gross proceeds reporting, the year in which the short sale is entered into). This rule does not, however, apply to any short sale that results in a constructive sale under section 1259 with respect to property held in the account in which the short sale is entered into. As a result of this rule, gross proceeds and basis reporting for a constructive sale is required in the year in which the short sale resulting in the constructive sale is entered into so long as the short sale is made in the account in which the taxpayer holds the relevant property.

Reporting requirements for options

The provision generally eliminates the present-law regulatory exception from section 6045(a) reporting for certain options. If a covered security is acquired by the exercise of an option, or is delivered to satisfy the exercise of an option, and the option was granted or acquired in the same account as the covered security, the amount of the premium received or paid for the option is treated as an adjustment to the gross proceeds from the subsequent sale of the covered security or as an adjustment to the customer's adjusted basis in that security. Gross proceeds and basis reporting also generally is required when there is a lapse of, or a closing transaction with respect to, an option on a specified security. These reporting rules related to options transactions apply only to options granted or acquired on or after January 1, 2011.

Treatment of S corporations

The provision provides that for purposes of section 6045, an S corporation (other than a financial institution) is treated in the same manner as a partnership. This rule applies to any sale of a covered security acquired by an S corporation (other than a financial institution) after December 31, 2010. When this rule takes effect, brokers generally will be required to report gross proceeds and basis information to customers that are S corporations.

Time for providing statements to customers; Treasury Department study

For payments made during any calendar year starting in 2010, the provision changes to February 15 the present-law January 31 deadline for furnishing certain information statements to customers. The statements to which the new February 15 deadline applies are (1) statements showing gross proceeds (under section 6045(b)) or substitute payments (under section 6045(d)) and (2) consolidated reporting statements (as defined in regulations) for reporting gross proceeds, dividends (under section 6042(c)), interest (under section 6049(c)(2)(A)), or royalties (under section 6050N(b)). The term "consolidated reporting statement" is intended to refer to annual tax information statements that brokerage firms customarily provide to their customers.

The provision requires the Secretary of the Treasury to study the effect and feasibility of delaying until February 15 the date for furnishing information statements for dividends, gross proceeds, interest, and royalties. Within six months after the date of enactment, the Secretary of the Treasury is required to report to Congress on the results of this study. The report must include the Secretary's findings regarding (1) the effect on tax administration of delaying the reporting date and (2) administrative or legislative options that are related to the affected information statements and that are intended to improve compliance and ease burdens on taxpayers and brokers.

Broker-to-broker and issuer reporting

Every broker (as defined in section 6045(c)(1)), and any other person specified in Treasury regulations, that transfers to a broker (as defined in section 6045(c)(1)) a security that is a covered security when held by that broker or other person must, under new section 6045A, furnish to the transferee broker a written statement that allows the transferee broker to satisfy the provision's basis and holding period reporting requirements. The Secretary may provide regulations that prescribe the content of this statement and the manner in which it must be furnished. It is contemplated that the Secretary will permit this broker-to-broker reporting requirement to be satisfied electronically rather than by paper. The statement required by this rule must be furnished within 45 days after the transfer of the covered security or, if earlier, by January 15 of the year in which the transfer occurred.

Present law penalties for failure to furnish correct payee statements apply to failures to furnish correct statements in connection with the transfer of covered securities.

New section 6045B requires, according to forms or regulations prescribed by the Secretary, any issuer of a specified security to file a return setting forth a description of any organizational action (such as a stock split or a merger or acquisition) that affects the basis of the specified security, the quantitative effect on the basis of that specified security, and any other information required by the Secretary. This return must be filed within 45 days after the date of the organizational action or, if earlier, by January 15 of the year following the calendar year during which the action occurred. Every person required to file this return for a specified security also must furnish, according to forms or regulations prescribed by the Secretary, to the nominee with respect to that security (or to a certificate holder if there is no nominee) a written statement showing the name, address, and phone number of the information contact of the person required to file the return, the information required to be included on the return with respect to the security, and any other information required by the Secretary. This statement must be furnished to the nominee or certificate holder on or before January 15 of the year following the calendar year in which the organizational action took place. No return or information statement is required to be provided under new section 6045B for any action with respect to a specified security if the action occurs before the applicable date (as defined previously) for that security.

The Secretary may waive the return filing and information statement requirements if the person to which the requirements apply makes publicly available, in the form and manner determined by the Secretary, the name, address, phone number, and email address of the information contact of that person, and the information about the organizational action and its effect on basis otherwise required to be included in the return.

The present-law penalties for failure to file correct information returns apply to failures to file correct returns in connection with organizational actions. Similarly, the present-law penalties for failure to furnish correct payee statements apply to a failure under new section 6045B to furnish correct statements to nominees or holders or to provide required publicly-available information in lieu of returns and written statements.

Effective Date

The provision takes effect on January 1, 2009.

5. Extension of federal unemployment surtax (sec. 1565 of the bill and sec. 3301 of the Code)

Present Law

The Federal Unemployment Tax Act ("FUTA") imposes a 6.2 percent gross tax rate on the first $7,000 paid annually by covered employers to each employee. Employers in States with programs approved by the Federal Government and with no delinquent Federal loans may credit 5.4 percentage points against the 6.2 percent tax rate, making the minimum, net Federal unemployment tax rate 0.8 percent. Since all States have approved programs, 0.8 percent is the Federal tax rate that generally applies. This Federal revenue finances administration of the unemployment system, half of the Federal-State extended benefits program, and a Federal account for State loans. The States use the revenue turned back to them by the 5.4 percent credit to finance their regular State programs and half of the Federal-State extended benefits program.

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8 percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent. The temporary surtax subsequently has been extended through 2007.

Explanation of Provision

The provision extends the temporary surtax rate through December 31, 2008.

Effective Date

The provision is effective for labor performed on or after January 1, 2008.

6. Termination of treatment of natural gas distribution lines 15-year property (sec. 1566 of the bill and sec. 168(e) 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.[176] The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[177] In the Revenue Procedure, natural gas distribution pipelines are assigned a class life of 35 years and a 20-year recovery period. However, natural gas distribution pipelines the original use of which commences with the taxpayer after April 11, 2005, and which are placed in service before January 1, 2011 are assigned a 15-year recovery period.[178]

Explanation of Provision

Under the provision, the temporary 15-year recovery period for natural gas distribution lines is repealed for property placed in service after December 3, 2007, unless the taxpayer has entered into a binding contract for the construction thereof on or before December 3, 2007, or, in the case of self-constructed property, has started construction on or before December 3, 2007.

Effective Date

The provision is effective for property placed in service after December 3, 2007, unless the taxpayer has entered into a binding contract for the construction thereof on or before December 3, 2007, or, in the case of self-constructed property, has started construction on or before December 3, 2007.

7. Modifications to corporate estimated tax payments (sec. 1567 of the Code)

Present Law

In general, corporations are required to make quarterly estimated tax payments of their income tax liability. For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

Under present law, in the case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2012, shall be increased to 115.0 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

Explanation of Provision

The provision increases the otherwise applicable percentage for payments due in July, August, and September 2012 (115.00 percent) by four percentage points.

Effective Date

The provision is effective on the date of enactment.

---

[176] Sec. 168.

[177] 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

[178] Sec. 168(e)(3)(E)(viii).

8. Increase in penalty for failure to file partnership returns (sec. 1568 of the bill and sec. 6698 of the Code)

Present Law

A partnership generally is treated as a pass-through entity. Income earned by a partnership, whether distributed or not, is taxed to the partners. Distributions from the partnership generally are tax-free. The items of income, gain, loss, deduction or credit of a partnership generally are taken into account by a partner as allocated under the terms of the partnership agreement. If the agreement does not provide for an allocation, or the agreed allocation does not have substantial economic effect, then the items are to be allocated in accordance with the partners' interests in the partnership. To prevent double taxation of these items, a partner's basis in its interest is increased by its share of partnership income (including tax-exempt income), and is decreased by its share of any losses (including nondeductible losses).

Under present law, a partnership is required to file a tax return for each taxable year. The partnership's tax return is required to include the names and addresses of the individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual. In addition to applicable criminal penalties, present law imposes a civil penalty for the failure to timely file a partnership return. The penalty is $50 per partner for each month (or fraction of a month) that the failure continues, up to a maximum of five months.

Explanation of Provisions

The provision increases the present-law failure to file penalty for partnership returns to $80 per partner times the number of shareholders in the partnership during any part of the taxable year for which the return was required, for each month (or a fraction of a month) during which the failure continues, up to a maximum of 12 months.

Effective Date

The provision applies to returns required to be filed after the date of enactment.