

**TECHNICAL EXPLANATION  
OF THE REVENUE PROVISIONS  
OF H.R. 4440,  
THE “GULF OPPORTUNITY ZONE ACT OF 2005”  
AS PASSED BY THE HOUSE OF REPRESENTATIVES  
AND THE SENATE**

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of the  
JOINT COMMITTEE ON TAXATION



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## INTRODUCTION

This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a Technical Explanation of the Revenue Provisions of H.R. 4440, the Gulf Opportunity Zone Act of 2005 as passed by the House of Representatives and the Senate.<sup>2</sup> Concurrent with Senate passage of the bill on that date, Senator Grassley, Chairman of the Senate Committee on Finance, included this description as a statement for the record in the Congressional Record. In the House of Representatives, Congressman McCrery stated at the time the bill passed, "Members of the other body have placed a document prepared by the Joint Committee on Taxation in the Congressional Record that explains the legislative intent with respect to H.R. 4440 as amended. The Joint Committee will also make this explanation public. This document expresses our understanding of the bill now before us and it will be a useful reference in understanding the legislation before us."

The bill provides tax benefits for the Gulf Opportunity Zone and certain areas affected by Hurricanes Rita and Wilma. It also includes tax and trade technical corrections. Finally, the bill provides that any of its provisions causing an effect on receipts, budget authority, or outlays is designated as an emergency requirement pursuant to section 402 of H. Con. Res. 95 (109<sup>th</sup> Congress).

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of H.R. 4440, the "Gulf Opportunity Zone Act of 2005," as Passed by the House of Representatives and the Senate.* (JCX-88-05), December 16, 2005.

<sup>2</sup> Several provisions in this bill that relate to Hurricane Rita and Hurricane Wilma are similar to provisions in Pub. L. No 109-73, the "Katrina Emergency Tax Relief Act of 2005," enacted September 23, 2005. For a description of that Act, see Joint Committee on Taxation, *Technical Explanation of H.R. 3768, the "Katrina Emergency Tax Relief Act of 2005," as Passed by the House and the Senate on September 21, 2005,* (JCX-69-05), September 22, 2005.

## **TITLE I – ESTABLISHMENT OF GULF OPPORTUNITY ZONE**

### **A. Tax Benefits for Gulf Opportunity Zone**

#### **1. Definitions of “Gulf Opportunity Zone,” “Rita GO Zone,” “Wilma GO Zone,” and other definitions (new sec. 1400M of the Code)**

##### **General Definitions**

##### **Gulf Opportunity Zone**

For purposes of the bill, the “Gulf Opportunity Zone” is defined as that portion of the Hurricane Katrina Disaster Area determined by the President to warrant individual or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.

##### **Hurricane Katrina disaster area**

The term “Hurricane Katrina disaster area” means an area with respect to which a major disaster has been declared by the President before September 14, 2005, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.

##### **Rita GO Zone**

The term “Rita GO Zone” means that portion of the Hurricane Rita disaster area determined by the President to warrant individual or individual and public assistance from the Federal Government under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Rita.

##### **Hurricane Rita disaster area**

The term “Hurricane Rita disaster area” means an area with respect to which a major disaster has been declared by the President before October 6, 2005, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act, by reason of Hurricane Rita.

##### **Wilma GO Zone**

The term “Wilma GO Zone” means that portion of the Hurricane Wilma disaster area determined by the President to warrant individual or individual and public assistance from the Federal Government under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Wilma.

## **Hurricane Wilma disaster area**

The term “Hurricane Wilma disaster area” means an area with respect to which a major disaster has been declared by the President before November 14, 2005, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act, by reason of Hurricane Wilma.

## **2. Tax-exempt bond financing for the Gulf Opportunity Zone (new sec. 1400N(a) of the Code)**

### **Present Law**

#### **Rules governing issuance of tax-exempt bonds**

##### **In general**

Under present law, gross income does not include interest on State or local bonds (sec. 103). State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes (“qualified private activity bonds”).

##### **Private activities eligible for financing with tax-exempt bonds**

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 (sec. 141(e)). 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 (sec. 142(a)).

As noted above, subject to certain requirements, qualified private activity bonds may be issued to finance residential rental property or owner-occupied housing. Residential rental property may be financed with exempt facility bonds if the financed project is a “qualified residential rental project.” A project is a qualified residential rental project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the “20-50 test”). Alternatively, a project is a qualified residential rental project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the “40-60 test”).

Owner-occupied housing may be financed with qualified mortgage bonds. Qualified mortgage bonds are bonds issued to make mortgage loans to qualified mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers and purchase price limitations for the home financed with bond proceeds. The income limitations are satisfied if all financing provided by an issue is provided for mortgagors whose family income does not exceed 115 percent of the median family income for the metropolitan area or State, whichever is greater, in which the financed residences are located. The purchase price limitations provide that a residence financed with qualified mortgage bonds may not have a purchase price in excess of 90 percent of the average area purchase price for that residence. In addition to these limitations, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the “first-time homebuyer” requirement).

Special income and purchase price limitations apply to targeted area residences. A targeted area residence is one located in either (1) a census tract in which at least 70 percent of the families have an income which is 80 percent or less of the state-wide median income or (2) an area of chronic economic distress. For targeted area residences, the income limitation is satisfied when no more than one-third of the mortgages are made without regard to any income limits and the remainder of the mortgages are made to mortgagors whose family income is 140 percent or less of the applicable median family income. The purchase price limitation is raised from 90 percent to 110 percent of the average area purchase price for targeted area residences. In addition, the first-time homebuyer requirement does not apply to targeted area residences.

Qualified mortgage bonds also may be used to finance qualified home-improvement loans. Qualified home-improvement loans are defined as loans to finance alterations, repairs, and improvements on an existing residence, but only if such alterations, repairs, and improvements substantially protect or improve the basic livability or energy efficiency of the property. Under present law, qualified home-improvement loans may not exceed \$15,000.

Issuance of most qualified private activity bonds is subject (in whole or in part) to annual State volume limitations (sec. 146)). Exceptions are provided for bonds for certain governmentally owned facilities (e.g., airports, ports, high-speed intercity rail, and solid waste disposal) and bonds which are subject to separate local, State, or national volume limits (e.g., public/private educational facility bonds, enterprise zone facility bonds, qualified green building bonds, and qualified highway or surface freight transfer facility bonds).

In addition, qualified private activity bonds generally are subject to restrictions on the use of proceeds for the acquisition of land and existing property, use of proceeds to finance certain specified facilities (e.g., airplanes, skyboxes, other luxury boxes, health club facilities, gambling facilities, and liquor stores), and use of proceeds to pay costs of issuance (e.g., bond counsel and underwriter fees). Small issue and redevelopment bonds also are subject to additional restrictions on the use of proceeds for certain facilities (e.g., golf courses and massage parlors).

Moreover, the term of qualified private activity bonds generally may not exceed 120 percent of the economic life of the property being financed and certain public approval

requirements (similar to requirements that typically apply under State law to issuance of governmental debt) apply under Federal law to issuance of private activity bonds.

### Liberty Zone Bonds

Present law permits an aggregate of \$8 billion in exempt facility bonds for the purpose of financing the construction and rehabilitation of nonresidential real property and residential rental real property in a designated “Liberty Zone” (the “Zone”) of New York City (“Liberty Zone bonds”). The Zone consists of all business addresses 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. No more than \$800 million of the authorized bond amount may be used to finance property used for retail sales of tangible property (e.g., department stores, restaurants, etc.) and functionally related and subordinate property. The \$800 million limit is divided equally between the Mayor of New York City and the Governor of New York State. In addition, no more than \$1.6 billion of the authorized bond amount may be used to finance residential rental property. The \$1.6 billion limit also is divided equally between the Mayor of New York City and the Governor of New York State. Liberty Zone Bonds must be issued before January 1, 2010.

Property eligible for financing with these bonds includes buildings and their structural components, fixed tenant improvements, and public utility property (e.g., gas, water, electric and telecommunication lines). Fixtures and equipment that could be removed from the designated zone for use elsewhere are not eligible for financing with these bonds. Issuance of these bonds is limited to projects approved by the Mayor of New York City or the Governor of New York State, each of whom may designate up to \$4 billion of the aggregate bond authority.

### Arbitrage restrictions on tax-exempt bonds

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

## **Explanation of Provision**

### **Gulf Opportunity Zone Bonds**

The provision authorizes the issuance of qualified private activity bonds to finance the construction and rehabilitation of residential and nonresidential property located in the Gulf Opportunity Zone (“Gulf Opportunity Zone Bonds”). Gulf Opportunity Zone Bonds must be issued after the date of enactment and before January 1, 2011.

Gulf Opportunity Zone Bonds may be issued by the State of Alabama, Louisiana, or Mississippi, or any political subdivision thereof. Issuance of bonds authorized under the provision is limited to projects approved by the Governor of the State (or the State bond commission in the case of a bond which is required under State law to be approved by such commission) in which the financed project shall be located. The maximum aggregate face amount of Gulf Opportunity Zone Bonds that may be issued in any State is limited to \$2,500 multiplied by the population of the respective State within the Gulf Opportunity Zone. Current refundings of outstanding bonds issued under the provision do not count against the aggregate volume limit to the extent that the principal amount of the refunding bonds does not exceed the outstanding principal amount of the bonds being refunded. Gulf Opportunity Zone Bonds may not be advance refunded.

Depending on the purpose for which such bonds are issued, Gulf Opportunity Zone Bonds are treated as either exempt facility bonds or qualified mortgage bonds. Gulf Opportunity Zone Bonds are treated as exempt facility bonds if 95 percent or more of the net proceeds of such bonds are to be used for qualified project costs located in the Gulf Opportunity Zone. Qualified project costs include the cost of acquisition, construction, reconstruction, and renovation of nonresidential real property (including buildings and their structural components and fixed improvements associated with such property), qualified residential rental projects (as defined in section 142(d) with certain modifications), and public utility property. For purposes of the provision, costs associated with improving a facility (e.g., installing equipment that enhances the pollution control of a manufacturing facility) may be permitted project costs if such costs are chargeable to the capital account of the facility or would be so chargeable either with a proper election by a taxpayer or but for a proper election by a taxpayer to deduct the costs.

Bond proceeds may not be used to finance movable fixtures and equipment. The purpose of this limitation is to ensure that property financed with the bonds will remain in the Gulf Opportunity Zone. "Movable fixtures and equipment" does not include components that are assembled to construct an industrial plant. Such term also does not include consumer appliances installed in owner-occupied residences and residential rental property financed with the proceeds of Gulf Opportunity Zone Bonds.

Rather than applying the 20-50 and 40-60 test under present law, a project is a qualified residential rental project under the provision if 20 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income or if 40 percent or more of the residential units in such project are occupied by individuals whose income is 70 percent or less of area median gross income.

Gulf Opportunity Zone Bonds are treated as qualified mortgage bonds if the bonds of such issue meet the requirements of a qualified mortgage issue (as defined in section 143 and modified by this provision) and the residences financed with such bonds are located in the Gulf Opportunity Zone. For these purposes, residences located in the Gulf Opportunity Zone are treated as targeted area residences. Thus, the first-time homebuyer rule is waived and purchase and income rules for targeted area residences apply to residences financed with bonds issued under the provision. Under the provision, 100 percent of the mortgages must be made to mortgagors whose family income is 140 percent or less of the applicable median family income. Thus, the present law rule allowing one-third of the mortgages to be made without regard to any

income limits does not apply. In addition, the provision increases from \$15,000 to \$150,000 the amount of a qualified home-improvement loan that may be financed with bond proceeds.

Subject to the following exceptions and modifications, issuance of Gulf Opportunity Zone Bonds is subject to the general rules applicable to issuance of qualified private activity bonds:

- (1) Except as otherwise permitted for a qualified mortgage issue, repayments of bond-financed loans may not be used to make additional loans;
- (2) Issuance of the bonds is not subject to the aggregate annual State private activity bond volume limits (sec. 146);
- (3) The restriction on acquisition of existing property is applied using a minimum requirement of 50 percent of the cost of acquiring the building being devoted to rehabilitation (sec. 147(d));
- (4) The special arbitrage expenditure rules for certain construction bond proceeds apply to available construction proceeds of Gulf Opportunity Zone Bonds issued to finance qualified project costs, treating such bonds as a construction issue (sec. 148(f)(4)(C));
- (5) Interest on the bonds is not a preference item for purposes of the alternative minimum tax preference for private activity bond interest (sec. 57(a)(5)); and
- (6) No portion of the proceeds of the bonds may be used to provide any property described in section 144(c)(6)(B) (i.e., any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal purpose of which is the sale alcoholic beverages for consumption off premises).

#### **Effective Date**

The provision is effective for bonds issued after the date of enactment and before January 1, 2011.

### **3. Advance refunding of certain tax-exempt bonds (new sec. 1400N(b) of the Code)**

#### **Present Law**

##### **In general**

Interest on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units (“governmental bonds”). Interest on State or local bonds to finance activities of private persons (“private activity bonds”) is taxable unless a specific exception applies. Bonds issued to finance the activities of charitable organizations described in section 501(c)(3)

(“qualified 501(c)(3) bonds”) are one type of tax-exempt private activity bonds (“qualified private activity bonds”). Qualified private activity bonds also include exempt facility bonds. The definition of exempt facility bonds includes bonds issued to finance certain transportation facilities (e.g., airports, docks, and wharves).

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

### **Limitations on advance refundings**

A refunding bond is defined as any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond). The Code contains different rules for “current” as opposed to “advance” refunding bonds. A current refunding occurs when the refunded bond is redeemed within 90 days of issuance of the refunding bonds. Conversely, a bond is classified as an advance refunding bond if it is issued more than 90 days before the redemption of the refunded bond (sec. 149(d)(5)). Proceeds of advance refunding bonds are generally invested in an escrow account and held until a future date when the refunded bond may be redeemed. Thus, after issuance of an advance refunding bond, there is a period of time when both the refunding bonds and the refunded bonds remain outstanding.

There is no statutory limitation on the number of times that tax-exempt bonds may be currently refunded. However, the Code limits the number of advance refundings with tax-exempt bonds. Generally, governmental bonds and qualified 501(c)(3) bonds may be advance refunded one time (sec. 149(d)(3)). Private activity bonds, other than qualified 501(c)(3) bonds, may not be advance refunded.

Under present law, certain bonds used to fund facilities located in New York City are permitted one additional advance refunding if issued before January 1, 2006. In addition to satisfying other requirements, the bond refunded must be (1) a State or local bond that is a general obligation of New York City, (2) a State or local bond issued by the New York Municipal Water Finance Authority or Metropolitan Transportation Authority of New York City, or (3) a qualified 501(c)(3) bond which is a qualified hospital bond issued by or on behalf of the State of New York or New York City. The maximum amount of additional advance refunding bonds that may be issued is \$9 billion.

## **Arbitrage restrictions on tax-exempt bonds**

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

### **Explanation of Provision**

The provision permits an additional advance refunding of certain governmental and qualified 501(c)(3) bonds issued by the State of Alabama, Louisiana, or Mississippi, or any political subdivision thereof. The provision also permits one advance refunding of certain exempt facility bonds for airports, docks, or wharves issued by the State of Alabama, Louisiana, or Mississippi, or any political subdivision thereof, notwithstanding the general prohibition on the advance refunding of such bonds.

The advance refunding authority under this provision only applies to bonds issued by the State of Alabama, Louisiana, or Mississippi, or any political subdivision thereof, which were outstanding on August 28, 2005, and could not be advance refunded under Code restrictions in effect on that date. (Although section 1400L(e)(4)(A) refers to restrictions on advance refundings under “any provision of law,” rather than under the “Code,” no inference should be drawn from the use of different terms). Further, to be eligible for the additional advance refunding, the advance refunding bond must be the only other outstanding bond with respect to the refunded bond. Thus, at no time after the advance refunding authorized under the provision occurs may there be more than two sets of bonds outstanding.

The maximum amount of advance refunding bonds that may be issued pursuant to this provision is \$4.5 billion in the case of Louisiana, \$2.250 billion in the case of Mississippi, and \$1.125 billion in the case of Alabama. Eligible advance refunding bonds must be designated as such by the governor of the respective State. Advance refunding bonds issued under the provision must satisfy present-law arbitrage restrictions and all requirements otherwise applicable to advance refunding issues (e.g., redemption requirements and prohibition on abusive transactions). Moreover, bonds may not be advance refunded under this provision if any portion of the proceeds of such bonds was used to provide any property described in section 144(c)(6)(B) (i.e., any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal purpose of which is the sale alcoholic beverages for consumption off premises).

### **Effective Date**

The provision is effective for advance refunding bonds issued after the date of enactment and before January 1, 2011.

#### **4. Increase the low-income housing credit cap and make other modifications (new sec. 1400N(c) of the Code)**

##### **Present Law**

##### **In general**

The low-income housing credit may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70 percent of the total qualified basis. The credit percentage for newly constructed or substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent of qualified basis. These are referred to as the 70-percent credit and 30-percent credit, respectively.

##### **Income targeting**

In order to be eligible for the low-income housing credit, a qualified low-income building must be part of a qualified low-income housing project. In general, a qualified low-income housing project is defined as a project which satisfies one of two tests at the election of the taxpayer. The first test is met if 20 percent or more of the residential units in the project are both rent-restricted and occupied by individuals whose income is 50 percent or less of area median gross income (the “20-50 test”). The second test is met if 40 percent or more of the residential units in such project are both rent-restricted and occupied by individuals whose income is 60 percent or less of area median gross income (the “40-60 test”).

##### **Credit cap**

Generally, the aggregate credit authority provided annually to each State for calendar year 2006 is \$1.90 per resident with a minimum annual cap of \$2,180,000 for certain small population States. These amounts are indexed for inflation. These limits do not apply in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit.

##### **Basis of building eligible for the credit**

Buildings located in high cost areas (i.e., qualified census tracts and difficult development areas) are eligible for an enhanced credit. Under the enhanced credit, the 70-percent and 30-percent credit is increased to a 91-percent and 39-percent credit, respectively. The mechanism for this increase is an increase from 100 to 130 percent of the otherwise applicable eligible basis of a new building or the rehabilitation expenditures of an existing building. A further requirement for the enhanced credit is that no more than 20 percent of the

population of each metropolitan statistical area or nonmetropolitan statistical area may be a difficult to develop area.

### **Stacking rule**

Authority to allocate credits remains at the State (as opposed to local) government level unless State law provides otherwise. Generally, credits may be allocated only from volume authority arising during the calendar year in which the building is placed in service, except in the case of: (1) credits claimed on additions to qualified basis; (2) credits allocated in a later year pursuant to an earlier binding commitment made no later than the year in which the building is placed in service; and (3) carryover allocations.

Each State annually receives low-income housing credit authority equal to \$1.90 per State resident for allocation to qualified low-income projects. In addition to this \$1.90 per resident amount, each State's "housing credit ceiling" includes the following amounts: (1) the unused State housing credit ceiling (if any) of such State for the preceding calendar year; (2) the amount of the State housing credit ceiling (if any) returned in the calendar year; and (3) the amount of the national pool (if any) allocated to such State by the Treasury Department.

The national pool consists of States' unused housing credit carryovers. For each State, the unused housing credit carryover for a calendar year consists of the excess (if any) of the unused State housing credit ceiling for such year over the excess (if any) of the aggregate housing credit dollar amount allocated for such year over the sum of \$1.90 per resident and the credit returns for such year. The amounts in the national pool are allocated only to States that allocated their entire housing credit ceiling for the preceding calendar year and requested a share in the national pool not later than May 1 of the calendar year. The national pool allocation to qualified States is made on a pro rata basis equivalent to the fraction that a State's population enjoys relative to the total population of all qualified States for that year.

The present-law stacking rule provides that each State is treated as using its allocation of the unused State housing credit ceiling (if any) from the preceding calendar before the current year's allocation of credit (including any credits returned to the State) and then finally any national pool allocations.

### **Explanation of Provision**

#### **Income targeting**

In the case of property placed in service during 2006, 2007, and 2008 in a nonmetropolitan area within the Gulf Opportunity Zone, the income targeting rules of the low-income housing credit are applied by replacing the area median gross income standard with a national nonmetropolitan median gross income standard. These new income targeting rules apply to all such buildings in the Gulf Opportunity Zone regardless of whether the building receives its credit allocation under the otherwise applicable low-income housing credit cap or the additional credit cap (described below). The income targeting rules are not changed for buildings in metropolitan areas in the Gulf Opportunity Zone.

### **Credit cap**

Under the provision, the otherwise applicable housing credit ceiling amount is increased for each of the States within the Gulf Opportunity Zone. This increase applies to calendar years 2006, 2007, and 2008. The additional credit cap for each of the affected States equals \$18.00 times the number of such State's residents within the Gulf Opportunity Zone. This amount is not adjusted for inflation. For purposes of this additional credit cap amount, the determination of population for any calendar year is made on the basis of the most recent census estimate of the resident population of the State in the Gulf Opportunity Zone released by the Bureau of the Census before August 28, 2005.

In addition, the otherwise applicable housing credit ceiling amount is increased for Florida and Texas by \$3,500,000 per State. This increase only applies to calendar year 2006.

### **Basis of building eligible for the credit**

Under the provision, the Gulf Opportunity Zone, the Rita Go Zone, and the Wilma Go Zone are treated as high-cost areas for purposes of the low income housing credit for property placed-in-service in calendar years 2006, 2007, and 2008. Therefore, buildings located in the Gulf Opportunity Zone, the Rita Go Zone, and the Wilma Go Zone are eligible for the enhanced credit. Under the enhanced credit, the 70-percent and 30-percent credits are increased to 91-percent and 39-percent credits, respectively. The 20-percent of population restriction is waived for this purpose. This enhanced credit applies regardless of whether the building receives its credit allocation under the otherwise applicable low-income housing credit cap or the additional credit cap.

### **Carryover**

The additional credit cap available for States within the Gulf Opportunity Zone for calendar years 2006, 2007 and 2008 may not be carried forward from any year to any other year. The present-law rules apply for purposes of the Rita Go Zone and the Wilma Go Zone.

### **Stacking rule**

Within each calendar year, each applicable State within the GO Zone must treat the additional credit cap allocable under the provision to that State as allocated before any other credit cap amounts. Therefore, under the provision each applicable State within the GO Zone is treated as using credits in the following order: (1) the additional credit cap (including any such credits returned to the State) under the Gulf Opportunity Zone, then (2) its allocation of the unused State housing credit ceiling (if any) from the preceding calendar, then (3) the current year's allocation of present-law credit (including any credits returned to the State) and then (4) any national pool allocations. This generally maximizes the total amount of credit (under both otherwise applicable low income housing credit cap and the additional credit cap for the Gulf Opportunity Zone) which may be carried forward.

The present-law rules apply for purposes of the Rita Go Zone and the Wilma Go Zone.

### Effective Date

The provisions relating to the increased credit cap, carryover and stacking rule applicable to the GO Zone are generally effective for calendar years beginning after 2005 and before 2009.

The provision relating to the increased credit cap applicable to Florida and Texas is generally effective for calendar years beginning after 2005 and before 2007.

The provision to treat the Gulf Opportunity Zone, Rita Go Zone and the Wilma Go Zone as a high-cost area is generally effective for calendar years beginning after 2005 and before 2009, and buildings placed-in-service during such period in the case of projects that also receive financing with the proceeds of tax-exempt bonds subject to the private activity bond volume limit which are issued during that period.

The income targeting provision is effective for property placed in service during 2006, 2007 and 2008. This provision applies to property which receives a credit allocation in any of those three years or a prior year. It also applies in the case of credit projects that receive tax-exempt bond financing subject to the private activity bond volume limit.

### **5. Additional first-year depreciation for Gulf Opportunity Zone property (new sec. 1400N(d) of the Code)**

#### Present Law

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

Section 280F limits the annual depreciation deductions with respect to passenger automobiles to specified dollar amounts, indexed for inflation.

Section 167(f)(1) provides that capitalized computer software costs, other than computer software to which section 197 applies, are recovered ratably over 36 months.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment generally may elect to deduct the cost of qualifying property placed in service for the taxable year. (Sec. 179.) 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.

### **Explanation of Provision**

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

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

In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be property to which the general rules of the Modified Accelerated Cost Recovery System ("MACRS") apply with (1) an applicable recovery period of 20 years or less, (2) computer software other than computer software covered by section 197, (3) water utility property (as defined in section 168(e)(5)), (4) certain leasehold improvement property, or (5) certain nonresidential real property and residential rental property. Second, substantially all of the use of such property must be in the Gulf Opportunity Zone and in the active conduct of a trade or business by the taxpayer in the Gulf Opportunity Zone. Third, the original use of the property in the Gulf Opportunity Zone must commence with the taxpayer on or after August 28, 2005. (Thus, used property may constitute qualified property so long as it has not previously been used within the Gulf Opportunity Zone. In addition, it is intended that additional capital expenditures incurred to recondition or rebuild property the original use of which in the Gulf Opportunity Zone began with the taxpayer would satisfy the "original use" requirement. See Treasury Regulation sec. 1.48-2 Example 5.) Finally, the property must be acquired by purchase (as defined under section 179(d)) by the taxpayer on or after August 28, 2005 and placed in service on or before December 31, 2007. For qualifying nonresidential real property and residential rental property, the property must be placed in service on or before December 31, 2008, in lieu of December 31, 2007. Property does not qualify if a binding written contract for the acquisition of such property was in effect before August 28, 2005. However, property is not precluded from qualifying for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to August 28, 2005.

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

another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

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

### **Effective Date**

The provision applies to property placed in service on or after August 28, 2005, in taxable years ending on or after such date.

## **6. Increase in expensing for Gulf Opportunity Zone property (new sec. 1400N(e) of the Code)**

### **Present Law**

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or “expense”) such costs. Present law provides that the maximum amount a taxpayer may expense, for taxable years beginning in 2003 through 2007, is \$100,000 of the cost of qualifying property placed in service for the taxable year. Additional section 179 incentives are provided with respect to a qualified property used by a business in the New York Liberty Zone (sec. 1400L(f)), an empowerment zone (sec. 1397A), or a renewal community (sec. 1400J). 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 computer software placed in service in taxable years beginning before 2008 is treated as qualifying property. The \$100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$400,000. The \$100,000 and \$400,000 amounts are indexed for inflation for taxable years beginning after 2003 and before 2008.

For taxable years beginning in 2008 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000.

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.

An expensing election is made under rules prescribed by the Secretary (sec. 179(c)(1)). Under Treas. Reg. sec. 179-5, applicable to property placed in service in taxable years beginning

after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. For taxable years beginning in 2008 and thereafter, an expensing election may be revoked only with consent of the Commissioner (sec. 179(c)(2)).

### **Explanation of Provision**

Under the provision, the \$100,000 maximum amount that a taxpayer may elect to deduct under section 179 is increased by the lesser of \$100,000, or the cost of qualified section 179 Gulf Opportunity Zone property for the taxable year. The provision applies with respect to qualified section 179 Gulf Opportunity Zone property acquired on or after August 28, 2005, and placed in service on or before December 31, 2007. Thus, in addition to the \$100,000 maximum cost of any section 179 property (including property that also meets the definition of qualified section 179 Gulf Opportunity Zone property) that may be deducted under present law, a taxpayer may elect to deduct a maximum \$100,000 additional amount of the taxpayer's cost of qualified section 179 Gulf Opportunity Zone property, resulting in a maximum deductible amount of \$200,000 of qualified section 179 Gulf Opportunity Zone property. (The \$100,000 present-law portion of this amount is indexed for taxable years beginning after 2003 and before 2008, so the total may be higher than \$200,000 after taking indexation of this portion into account.) The \$100,000 additional amount for the cost of qualified section 179 Gulf Opportunity Zone property is not indexed.

The provision provides a special rule for the reduction in the \$200,000 maximum deduction for the cost of qualified section 179 Gulf Opportunity Zone property. Under this rule, the \$200,000 amount is reduced (but not below zero) by the amount by which the cost of qualified section 179 Gulf Opportunity Zone property placed in service during the taxable year exceeds a dollar cap of up to \$1 million. (The \$400,000 present-law portion of this amount is indexed for taxable years beginning after 2003 and before 2008, so the total may be higher than \$1 million after taking indexation of this portion into account.) The dollar cap is computed by increasing the \$400,000 present-law amount by the lesser of (1) \$600,000, or (2) the cost of qualified section 179 Gulf Opportunity Zone property placed in service during the taxable year. The \$600,000 amount is not indexed.

The operation of the reduction may be illustrated as follows. In each of the following examples, assume that the taxable income limitation of section 179(b)(3)(A) does not cause a reduction in the amount that may be expensed for the taxable year. For example, assume that in the taxable year, a taxpayer's cost of section 179 property that is qualified Gulf Opportunity Zone property is \$800,000, and in that year the taxpayer acquires no other section 179 property. Under the provision, the taxpayer's deductible amount is increased by \$100,000 to \$200,000 (the lesser of \$100,000 and cost of the taxpayer's qualified section 179 Gulf Opportunity Zone property). Under the provision, the \$400,000 phase-out amount in section 179(b)(2) is increased by \$600,000 (i.e., the lesser of \$600,000 or the \$800,000 cost of qualified section 179 Gulf Opportunity Zone property), so that the phase-out amount is \$1 million. The taxpayer's cost of section 179 property is \$800,000 in total (less than the \$1 million phase-out amount), so no reduction is made in the \$200,000 amount of qualified Gulf Opportunity Zone property that may be deducted under section 179 for the taxable year. As another example, assume for the taxable

year that a taxpayer's cost of section 179 property that is qualified Gulf Opportunity Zone property is \$200,000, and its cost of other section 179 property is \$450,000. Under the provision, the \$400,000 phase-out amount in section 179(b)(2) is increased to \$600,000 by the \$200,000 cost of qualified section 179 Gulf Opportunity Zone property. The taxpayer had a total \$650,000 cost of section 179 property for the taxable year. The taxpayer's section 179 deduction is reduced by the \$50,000 difference between \$650,000 and \$600,000. Thus, under the provision, the taxpayer may deduct \$150,000 (\$200,000 less \$50,000) under section 179 for the taxable year.

Qualified section 179 Gulf Opportunity Zone property means section 179 property (as defined in section 179(d) of present law) that also meets the requirements to qualify for Gulf Opportunity Zone bonus depreciation. Specifically, for section 179 purposes, qualified Gulf Opportunity Zone property is property (1) described in section 168(k)(2)(A)(i), (2) substantially all of the use of which is in the Gulf Opportunity Zone and is in the active conduct of a trade or business by the taxpayer in that Zone, (3) the original use of which commences with the taxpayer on or after August 28, 2005, (4) which is acquired by the taxpayer by purchase on or after August 28, 2005, but only if no written binding contract for the acquisition was in effect before August 28, 2005, and (5) which is placed in service by the taxpayer on or before December 31, 2007. Such property does not include alternative depreciation property, tax-exempt bond-financed property, or qualified revitalization buildings.

The provision includes rules coordinating increased section 179 amounts provided under the bill with present-law expensing rules with respect to enterprise zone businesses in empowerment zones and with respect to renewal communities. For purposes of those rules, qualified section 179 Gulf Opportunity Zone property is not treated as qualified zone property or qualified renewal property, unless the taxpayer elects not to take such qualified section 179 Gulf Opportunity Zone property into account for purposes of this provision. Thus, a taxpayer acquiring property that could qualify as either qualified section 179 Gulf Opportunity Zone property, or qualified zone property or qualified renewal property, may elect the additional expensing provided either under this provision, or under the empowerment zone or renewal community rules, but not both, with respect to the property.

Recapture rules apply under the provision if recapture applies under section 179(d)(10) or if the property ceases to be qualified section 179 Gulf Opportunity Zone property.

### **Effective Date**

The provision is effective for taxable years ending on or after August 28, 2005, for qualified section 179 Gulf Opportunity Zone property acquired after August 27, 2005, and placed in service on or before December 31, 2007.

## **7. Expensing for certain demolition and clean-up costs (new sec. 1400N(f) of the Code)**

### **Present Law**

Under present law, the cost of demolition of a structure is capitalized into the taxpayer's basis in the land on which the structure is located. (Sec. 280B). Land is not subject to an allowance for depreciation or amortization.

The treatment of the cost of debris removal depends on the nature of the costs incurred. For example, the cost of debris removal after a storm may in some cases constitute an ordinary and necessary business expense which is deductible in the year paid or incurred. In other cases, debris removal costs may be in the nature of replacement of part of the property that was damaged. In such cases, the costs are capitalized and added to the taxpayer's basis in the property. For example, Revenue Ruling 71-161, 1971-1 C.B. 76, permits the use of clean-up costs as a measure of casualty loss but requires that such costs be added to the post-casualty basis of the property.

### **Explanation of Provision**

Under the provision, a taxpayer is permitted a deduction for 50 percent of any qualified Gulf Opportunity Zone clean-up cost paid or incurred on or after August 28, 2005, and before January 1, 2008. The remaining 50 percent is capitalized as under present law.

A qualified Gulf Opportunity Zone clean-up cost is an amount paid or incurred for the removal of debris from, or the demolition of structures on, real property located in the Gulf Opportunity Zone to the extent that the amount would otherwise be capitalized. In order to qualify, the property must be held for use in a trade or business, for the production of income, or as inventory.

### **Effective Date**

The provision applies to costs paid or incurred on or after August 28, 2005 in taxable years ending on or after such date.

## **8. Extension of expensing for environmental remediation costs (new sec. 1400N(g) of the Code)**

### **Present Law**

Taxpayers may elect to deduct (or "expense") certain environmental remediation expenditures that would otherwise be chargeable to capital account, in the year paid or incurred (sec. 198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site.

A "qualified contaminated site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory and (2) is at a site on which there has been a release (or threat of release) or disposal of certain hazardous substances as certified by the appropriate State environmental agency (so-called "brownfields").

Section 198(d)(1) defines a "hazardous substance" as a substance which is so defined in section 101(14) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA"), and any substance which is administratively designated as a hazardous substance under section 102 of CERCLA. Under section 198(d)(2), however, the term "hazardous substance" does not include any substance with respect to which a removal or remediation is not permitted under section 104 of CERCLA by reason of subsection (a)(3)

thereof, which exempts from the scope of such provision “the release or threat of release (A) of a naturally occurring substance in its unaltered form, or altered solely through naturally occurring processes or phenomena, from a location where it is naturally found; (B) from products which are part of the structure of, and result in exposure within, residential buildings or business or community structures; or (C) into public or private drinking water supplies due to deterioration of the system through ordinary use.” However, sites which are identified on the national priorities list under CERCLA cannot qualify for expensing under section 198.

Petroleum products generally are not regarded as hazardous substances for purposes of section 198. Section 101(14) of CERCLA specifically excludes “petroleum, including crude oil or any fraction thereof which is not otherwise specifically listed or designated as a hazardous substance under subparagraphs (A) through (F) of this paragraph,” from the definition of “hazardous substance.”

Under present law, eligible expenditures are those paid or incurred before January 1, 2006.

#### **Explanation of Provision**

The provision extends the present-law expensing provision for two years (through December 31, 2007) for qualified contaminated sites located in the Gulf Opportunity Zone.

In addition, under the provision, petroleum products are treated as hazardous substances for purposes of applying the expensing provision (as extended) within the Gulf Opportunity Zone. Petroleum products are defined by reference to section 4612(a)(3), and include crude oil, crude oil condensates and natural gasoline. Thus, for example, the release of crude oil upon property held for use in a trade or business in the Gulf Opportunity Zone results in such property being treated as a qualified contaminated site. The present law exceptions for sites on the national priorities list under CERCLA, and for substances with respect to which a removal or remediation is not permitted under section 104 of CERCLA by reason of subsection (a)(3) thereof, would continue to apply to all hazardous substances (including petroleum products).

Expenditures paid or incurred to abate the contamination on or after August 28, 2005 and before December 31, 2007, would be eligible for expensing.

#### **Effective Date**

The provision is effective for taxable years ending on or after August 28, 2005.

### **9. Increase in rehabilitation tax credit with respect to certain buildings located in the Gulf Opportunity Zone (new sec. 1400N(h) of the Code)**

#### **Present Law**

Present law provides a two-tier tax credit for rehabilitation expenditures.

A 20-percent credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that

is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A 10-percent credit is provided for qualified rehabilitation expenditures with respect to a qualified rehabilitated building, which generally means a building that was first placed in service before 1936. The pre-1936 building must meet requirements with respect to retention of existing external walls and internal structural framework of the building in order for expenditures with respect to it to qualify for the 10-percent credit. A building is treated as having met the substantial rehabilitation requirement under the 10-percent credit only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or (2) \$5,000.

The provision requires the use of straight-line depreciation or the alternative depreciation system in order for rehabilitation expenditures to be treated as qualified under the provision.

#### **Explanation of Provision**

The provision increases from 20 to 26 percent, and from 10 to 13 percent, respectively, the credit under section 47 with respect to any certified historic structure or qualified rehabilitated building located in the Gulf Opportunity Zone, provided the qualified rehabilitation expenditures with respect to such buildings or structures are incurred on or after August 28, 2005, and before January 1, 2009.

#### **Effective Date**

The provision is effective for expenditures incurred on or after August 28, 2005, and before January 1, 2009, for taxable years ending on or after August 28, 2005.

### **10. Increased expensing for reforestation expenditures of small timber producers (new sec. 1400N(i)(1) of the Code)**

#### **Present Law**

Present law permits a taxpayer to elect to deduct (or “expense”) a limited amount of certain reforestation expenditures that would otherwise be required to be capitalized, in the year paid or incurred (sec. 194(b)). No more than \$10,000 of reforestation expenditures made by a taxpayer in any year can qualify for expensing with respect to each qualified timber property. The limit is reduced to \$5,000 per qualified timber property for married taxpayers filing separate returns.

All members of a controlled group of corporations are treated as a single taxpayer for purposes of the \$10,000 limit. A controlled group of corporations for purposes of section 194 is defined as under section 1563(a), except that the 80-percent ownership requirement is reduced to a more than 50-percent requirement. If a partnership or S corporation incurs reforestation expenditures, the \$10,000 limit applies separately to the partnership or S corporation and to each

partner or shareholder. For an estate with reforestation expenditures, the \$10,000 limit is apportioned between the estate and its beneficiaries. Section 194(b) does not apply to trusts.

Reforestation expenditures include direct costs incurred in connection with forestation or reforestation by planting or artificial or natural seeding, including costs for site preparation, seeds and seeding, labor and tools, and depreciation on equipment used in planting or seeding. Qualified timber property means a woodlot or other site located in the United States which will contain trees in significant commercial quantities and which is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products (sec. 194(c)(1)).

If a taxpayer's otherwise qualifying reforestation expenditures exceed the amount permitted to be expensed under section 194, the remaining expenditures are amortized, and the taxpayer is entitled to a deduction with respect to the amortization of the amortizable basis (sec. 194(a)). Reforestation expenditures qualifying for amortization are deducted in 84 equal monthly installments starting with the seventh month of the taxable year during which the expenditures are paid or incurred. Only reforestation expenditures that would otherwise be included in the basis of qualified timber property qualify for expensing and, with respect to amounts in excess of the \$10,000 limit, for amortization (however, costs that could be deducted in the absence of section 194 are not required to be amortized).

### **Explanation of Provision**

The provision doubles, for certain taxpayers, the present-law expensing limit for reforestation expenditures paid or incurred by such taxpayers (i) during the period after on or August 28, 2005, and before January 1, 2008, with respect to qualified timber property any portion of which is located in the Gulf Opportunity Zone, (ii) during the period on or after September 23, 2005, and before January 1, 2008, with respect to qualified timber property any portion of which is located in the Rita Zone and no portion of which is located in the Gulf Opportunity Zone, and (iii) during the period on or after October 23, 2005, and before January 1, 2008, with respect to qualified timber property any portion of which is located in the Wilma Zone. The amount by which the expensing limit is increased, however, is limited to the amount of reforestation expenditures paid or incurred during the relevant portion of the taxable year.

For example, suppose an otherwise eligible calendar-year taxpayer incurred \$20,000 of reforestation expenditures in June, 2005 (i.e., prior to the relevant period), and incurs an additional \$5,000 of reforestation expenditures in October, 2005, in the Gulf Opportunity Zone; the taxpayer would be permitted to expense \$15,000 of the expenditures (because the increase in the expensing limit is limited to the \$5,000 of expenditures paid or incurred during the relevant period within the taxable year) and could amortize the remaining \$10,000 under section 194(a). By contrast, if the taxpayer had incurred \$5,000 of reforestation expenditures in June, 2005, and incurs an additional \$20,000 of reforestation expenditures in October, 2005, then the taxpayer would be permitted to expense \$20,000 of the expenditures, and could amortize the remaining \$5,000 under section 194(a).

The provision applies to taxpayers with aggregate holdings of qualified timber property which do not exceed 500 acres at any time during the taxable year. "Qualified timber property"

is defined by section 194(c)(1) as “a woodlot or other site located in the United States which will contain trees in significant commercial quantities and which is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products.”

The provision does not apply to any taxpayer which is a corporation the stock of which is publicly traded on an established securities market, or which is a real estate investment trust.

### **Effective Date**

The proposal is effective for taxable years ending on or after August 28, 2005, (i) for expenditures paid or incurred on or after August 28, 2005, and before January 1, 2008, with respect to qualified timber property any portion of which is located in the Gulf Opportunity Zone, (ii) for expenditures paid or incurred on or after September 23, 2005, and before January 1, 2008, with respect to qualified timber property any portion of which is located in the Rita Zone and no portion of which located in the Gulf Opportunity Zone, and (iii) for expenditures paid or incurred on or after October 23, 2005, and before January 1, 2008, with respect to qualified timber property any portion of which is located in the Wilma Zone.

## **11. Five-year NOL carryback of certain timber losses (new sec. 1400N(i)(2) of the Code)**

### **Present Law**

A net operating loss (“NOL”) is, generally, the amount by which a taxpayer’s business deductions exceed the taxpayer’s gross income. In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in these years (sec. 172). NOLs generally are first applied to the earliest of the taxable years to which the loss may be carried (sec. 172(b)(2)).

In the case of an NOL arising from a farming loss, the NOL can be carried back five years. A “farming loss” is defined as the amount of any net operating loss attributable to a farming business as defined in section 263A(e)(4). Under section 263A(e)(4), a farming business includes the trade or business of farming, as well as the trade or business of operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees. It does not include the planting, cultivating, caring for, holding or cutting of trees for sale or use in the commercial production of timber products.

A farming loss cannot exceed the taxpayer's NOL for the taxable year. In calculating the amount of a taxpayer's NOL carrybacks, the portion of the NOL that is attributable to a farming loss is treated as a separate NOL and is taken into account after the remaining portion of the NOL for the taxable year.

### **Explanation of Provision**

Under the provision, for purposes of determining the farming loss (if any) of certain taxpayers, income and loss is treated as attributable to a farming business if such income and loss is attributable to qualified timber property any portion of which is located in the Gulf Opportunity Zone or in the Rita GO Zone, and if such income and loss is allocable to that portion

of the taxpayer's taxable year which is (i) on or after August 28, 2005 (for qualified timber property any portion of which is located in the Gulf Opportunity Zone), on or after September 23, 2005 (for qualified timber property any portion of which is located in the Rita GO Zone and no portion of which is located in the Gulf Opportunity Zone), or on or after October 23, 2005 (for qualified timber property any portion of which is located in the Wilma Zone) and (ii) before January 1, 2007. "Qualified timber property" is defined by section 194(c)(1) as "a woodlot or other site located in the United States which will contain trees in significant commercial quantities and which is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products."

The provision applies to taxpayers with aggregate holdings of qualified timber property which do not exceed 500 acres at any time during the taxable year. Further, the provision only applies (i) with respect to qualified timber property any portion of which is located in the Gulf Opportunity Zone, if the taxpayer held such property on August 28, 2005, (ii) with respect to qualified timber property any portion of which is located in the Rita GO Zone and no portion of which is located in the Gulf Opportunity Zone, if the taxpayer held such property on September 23, 2005, and (iii) with respect to qualified timber property any portion of which is located in the Wilma Zone, if the taxpayer held such property on October 23, 2005.

The provision does not apply to any taxpayer which is a corporation the stock of which is publicly traded on an established securities market, or which is a real estate investment trust.

#### **Effective Date**

The proposal is effective for taxable years ending on or after August 28, 2005, with respect to income and loss which is allocable to that portion of the taxpayer's taxable year which is (i) on or after August 28, 2005 (for qualified timber property any portion of which is located in the Gulf Opportunity Zone), on or after September 23, 2005 (for qualified timber property any portion of which is located in the Rita Zone and no portion of which is located in the Gulf Opportunity Zone), or on or after October 23, 2005 (for qualified timber property any portion of which is located in the Wilma Zone) and (ii) before January 1, 2007.

### **12. Special rule for Gulf Opportunity Zone public utility casualty losses (new sec. 1400N(j) of the Code)**

#### **Present Law**

##### **In general**

A net operating loss ("NOL") is, generally, the amount by which a taxpayer's allowable deductions exceed the taxpayer's gross income. A carryback of an NOL generally results in the refund of Federal income tax for the carryback year. A carryover of an NOL reduces Federal income tax for the carryover year.

In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years. NOLs generally are first applied to the earliest of the taxable years to which the loss may be carried.

### **Exceptions to the general rule**

Different rules apply with respect to NOLs arising in certain circumstances. For example, a three-year carryback applies with respect to NOLs (1) arising from casualty or theft losses of individuals, or (2) attributable to Presidentially declared disasters for taxpayers engaged in a farming business or a small business. A five-year carryback period applies to NOLs from a farming loss (regardless of whether the loss was incurred in a Presidentially declared disaster area). Special rules also apply to real estate investment trusts (no carryback), specified liability losses (10-year carryback), and excess interest losses (no carryback to any year preceding a corporate equity reduction transaction).

### **Specified liability losses**

The specified liability loss rules generally apply to certain product liability losses and other liability losses. The amount of the specified liability loss cannot exceed the taxpayer's NOL for the taxable year. A specified liability loss is treated as a separate NOL for the taxable year which is eligible for a 10-year carryback period. Any remaining portion of the taxpayer's NOL is subject to the general two-year carryback period.

### **Explanation of Provision**

The provision provides an election for taxpayers to treat any Gulf Opportunity Zone public utility casualty loss as a specified liability loss to which the present-law 10-year carryback period applies. A Gulf Opportunity Zone public utility casualty loss is any casualty loss of public utility property by reason of Hurricane Katrina which is allowed as a deduction under section 165. The amount of the casualty loss is reduced by the amount of any gain recognized by the taxpayer from involuntary conversions of public utility property located in the Gulf Opportunity Zone caused by Hurricane Katrina. The total amount of specified liability loss, including any amount of public utility casualty loss treated as such, is limited to the amount of the taxpayer's overall NOL for the taxable year as under present law. Taxpayers who elect the applicability of the proposed provision with respect to any loss are not eligible to also treat the loss as having occurred in any prior taxable year under section 165(i), nor may they include the casualty loss as part of the five-year NOL carryback provided under another provision of the bill.

For purposes of the proposed provision, public utility property is defined as in section 168(i)(10) to mean, generally, property used predominantly in a rate-regulated trade or business of the furnishing or sale of electrical energy, water, or sewage disposal services; gas or steam through a local distribution system; telephone services or certain other communication services; or transportation of gas or steam by pipeline.

### **Effective Date**

The provision is effective for losses arising in taxable years ending on or after August 28, 2005.

### **13. Five-year NOL carryback for certain amounts related to Hurricane Katrina or the Gulf Opportunity Zone (new sec. 1400N(k) of the Code)**

#### **Present Law**

##### **In general**

A net operating loss (“NOL”) is, generally, the amount by which a taxpayer’s allowable deductions exceed the taxpayer’s gross income. A carryback of an NOL generally results in the refund of Federal income tax for the carryback year. A carryover of an NOL reduces Federal income tax for the carryover year.

In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years. NOLs generally are first applied to the earliest of the taxable years to which the loss may be carried.

Different rules apply with respect to NOLs arising in certain circumstances. For example, a three-year carryback applies with respect to NOLs (1) arising from casualty or theft losses of individuals, or (2) attributable to Presidentially declared disasters for taxpayers engaged in a farming business or a small business. A five-year carryback period applies to NOLs from a farming loss (regardless of whether the loss was incurred in a Presidentially declared disaster area). Special rules also apply to real estate investment trusts (no carryback), specified liability losses (10-year carryback), and excess interest losses (no carryback to any year preceding a corporate equity reduction transaction).

Separately, under section 165(i), a taxpayer who incurs a loss attributable to a Presidentially declared disaster may elect to take such loss into account for the taxable year immediately preceding the taxable year in which the disaster occurred. This rule applies regardless of whether the taxpayer has an overall net operating loss for the relevant taxable years.

The alternative minimum tax rules provide that a taxpayer's NOL deduction cannot reduce the taxpayer's alternative minimum taxable income (“AMTI”) by more than 90 percent of the AMTI. However, an NOL deduction attributable to NOL carrybacks arising in taxable years ending in 2001 and 2002, as well as NOL carryforwards to these taxable years, offset 100 percent of a taxpayer's AMTI.

#### **Explanation of Provision**

##### **In general**

The provision provides a special five-year carryback period for NOLs to the extent of certain specified amounts related to Hurricane Katrina or the Gulf Opportunity Zone. The amount of the NOL which is eligible for the five year carryback (“eligible NOL”) is limited to the aggregate amount of the following deductions: (i) qualified Gulf Opportunity Zone casualty losses; (ii) certain moving expenses; (iii) certain temporary housing expenses; (iv) depreciation deductions with respect to qualified Gulf Opportunity Zone property for the taxable year the property is placed in service; and (v) deductions for certain repair expenses resulting from Hurricane Katrina. The provision applies for losses paid or incurred after August 27, 2005, and

before January 1, 2008; however, an irrevocable election not to apply the five-year carryback under the provision may be made with respect to any taxable year.

### **Qualified Gulf Opportunity Zone casualty losses**

The amount of qualified Gulf Opportunity Zone casualty losses which may be included in the eligible NOL is the amount of the taxpayer's casualty losses with respect to (1) property used in a trade or business, and (2) capital assets held for more than one year in connection with either a trade or business or a transaction entered into for profit. In order for a casualty loss to qualify, the property must be located in the Gulf Opportunity Zone and the loss must be attributable to Hurricane Katrina. As under present law, the amount of any casualty loss includes only the amount not compensated for by insurance or otherwise. In addition, the total amount of the casualty loss which may be included in the eligible NOL is reduced by the amount of any gain recognized by the taxpayer from involuntary conversions of property located in the Gulf Opportunity Zone caused by Hurricane Katrina.

To the extent that a casualty loss is included in the eligible NOL and carried back under the provision, the taxpayer is not eligible to also treat the loss as having occurred in the prior taxable year under section 165(i). Similarly, the five year carryback under the provision does not apply to any loss taken into account for purposes of the ten-year carryback of public utility casualty losses which is provided under another provision in the bill.

### **Moving expenses**

Certain employee moving expenses of an employer may be included in the eligible NOL. In order to qualify, an amount must be paid or incurred after August 27, 2005, and before January 1, 2008 with respect to an employee who (i) lived in the Gulf Opportunity Zone before August 28, 2005, (ii) was displaced from their home either temporarily or permanently as a result of Hurricane Katrina, and (iii) is employed in the Gulf Opportunity Zone by the taxpayer after the expense is paid or incurred.

For this purpose, moving expenses are defined as under present law to include only the reasonable expenses of moving household goods and personal effects from the former residence to the new residence, and of traveling (including lodging) from the former residence to the new place of residence. However, for purposes of the provision, the former residence and the new residence may be the same residence if the employee initially vacated the residence as a result of Hurricane Katrina. It is not necessary for the individual with respect to whom the moving expenses are incurred to have been an employee of the taxpayer at the time the expenses were incurred. Thus, assuming the other requirements are met, a taxpayer who pays the moving expenses of a prospective employee and subsequently employs the individual in the Gulf Opportunity Zone may include such expenses in the eligible NOL.

### **Temporary housing expenses**

Any deduction for expenses of an employer to temporarily house employees who are employed in the Gulf Opportunity Zone may be included in the eligible NOL. It is not necessary for the temporary housing to be located in the Gulf Opportunity Zone in order for such expenses to be included in the eligible NOL; however, the employee's principal place of employment with

the taxpayer must be in Gulf Opportunity Zone. So, for example, if a taxpayer temporarily houses an employee at a location outside of the Gulf Opportunity Zone, and the employee commutes into the Gulf Opportunity Zone to the employee's principal place of employment, such temporary housing costs will be included in the eligible NOL (assuming all other requirements are met).

### **Depreciation of Gulf Opportunity Zone property**

The eligible NOL includes the depreciation deduction (or amortization deduction in lieu of depreciation) with respect to qualified Gulf Opportunity Zone property placed in service during the year. The special carryback period applies to the entire allowable depreciation deduction for such property for the year in which it is placed in service, including both the regular depreciation deduction and the additional first-year depreciation deduction, if any. An election out of the additional first-year depreciation deduction for Gulf Opportunity Zone property does not preclude eligibility for the five-year carryback.

### **Repair expenses**

The eligible NOL includes deductions for repair expenses (including the cost of removal of debris) with respect to damage caused by Hurricane Katrina. For example, expenses relating to the removal of mold and other contaminants from property located in the Gulf Opportunity Zone will be included in the eligible NOL. In order to qualify, the amount must be paid or incurred after August 27, 2005 and before January 1, 2008, and the property must be located in the Gulf Opportunity Zone.

### **Other rules**

The amount of the NOL to which the five-year carryback period applies is limited to the amount of the corporation's overall NOL for the taxable year. Any remaining portion of the taxpayer's NOL is subject to the general two-year carryback period. Ordering rules similar to those for specified liability losses apply to losses carried back under the provision.

In addition, the general rule which limits a taxpayer's NOL deduction to 90 percent of AMTI will not apply to any NOL to which the five-year carryback period applies under the provision. Instead, a taxpayer may apply such NOL carrybacks to offset up to 100 percent of AMTI.

### **Effective Date**

The provision is effective for losses arising in taxable years ending on or after August 28, 2005.

## **14. Gulf Tax credit bonds (new sec. 1400N(l) of the Code)**

### **Present Law**

#### **In general**

Under present law, gross income does not include interest on State or local bonds (sec. 103). State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes (“qualified private activity bonds”).

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

#### **Tax-credit bonds**

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

#### **Arbitrage restrictions on tax-exempt bonds**

To prevent States and local governments from issuing more tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods” before funds are needed for the

purpose of the borrowing) or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, profits that are earned during these periods or on such investments must be rebated to the Federal Government. Governmental bonds are subject to less restrictive arbitrage rules than most private activity bonds.

### **Explanation of Provision**

The provision creates a new category of tax-credit bonds that may be issued in calendar year 2006 by the States of Louisiana, Mississippi, and Alabama (“Gulf Tax Credit Bonds”). As with present law tax-credit bonds, the taxpayer holding Gulf Tax Credit Bonds on the allowance date would be entitled to a tax credit. The amount of the credit would be determined by multiplying the bond’s credit rate by the face amount on the holder’s bond. The credit would be includible in gross income (as if it were an interest payment on the bond) and could be claimed against regular income tax liability and alternative minimum tax liability.

Under the provision, 95 percent or more of the proceeds of Gulf Tax Credit Bonds must be used to (i) pay principal, interest, or premium on a bond (other than a private activity bond) that was outstanding on August 28, 2005, and was issued by the State issuing the Gulf Tax Credit Bonds, or any political subdivision thereof, or (ii) make a loan to any political subdivision of such State to pay principal, interest, or premium on a bond (other than a private activity bond) issued by such political subdivision. In addition, the issuer of Gulf Tax Credit Bonds must provide additional funds to pay principal, interest, or premium on outstanding bonds equal to the amount of Gulf Tax Credit Bonds issued to repay such outstanding bonds. Gulf Tax Credit Bonds must be a general obligation of the issuing State and must be designated by the Governor of such issuing State. The maximum maturity on Gulf Tax Credit Bonds is two years. In addition, present-law arbitrage rules that restrict the ability of State and local governments to invest bond proceeds apply to Gulf Tax Credit Bonds.

The maximum amount of Gulf Tax Credit Bonds that may be issued pursuant to this provision is \$200 million in the case of Louisiana, \$100 million in the case of Mississippi, and \$50 million in the case of Alabama. Gulf Tax Credit Bonds may not be used to pay principal, interest, or premium on any bond with respect to which there is any outstanding refunded or refunding bond. Moreover, Gulf Tax Credit Bonds may not be used to pay principal, interest, or premium on any prior bond if the proceeds of such prior bond were used to provide any property described in section 144(c)(6)(B) (i.e., any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal purpose of which is the sale alcoholic beverages for consumption off premises).

### **Effective Date**

The provision is effective for bonds issued after December 31, 2005 and before January 1, 2007.

## **15. Additional allocation of new markets tax credit for investments that serve the Gulf Opportunity Zone (new sec. 1400N(m) of the Code)**

### **Present Law**

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

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE. A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder. Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.

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

The Secretary has the authority to designate “targeted populations” as low-income communities for purposes of the new markets tax credit. For this purpose, a “targeted population” is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4702(20)) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who (A) are low-income persons; or (B) otherwise lack adequate access to loans or equity investments. Under such Act, “low-income” means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income or 80 percent of the statewide non-metropolitan area median family income (12 U.S.C. 4702(17)). Under such Act, a targeted population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391, and is contiguous to one or more low-income communities.

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

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

#### **Explanation of Provision**

The provision allows an additional allocation of the new markets tax credit in an amount equal to \$300,000,000 for 2005 and 2006, and \$400,000,000 for 2007, to be allocated among qualified CDEs to make qualified low-income community investments within the Gulf Opportunity Zone. To qualify for any such allocation, a qualified CDE must have as a significant mission the recovery and redevelopment of the Gulf Opportunity Zone. The carryover of any unused additional allocation is applied separately from the carryover with respect to allocations made under present law.

#### **Effective Date**

The proposal is effective on the date of enactment.

## **16. Representations regarding income eligibility for purposes of qualified residential rental project requirements (new sec. 1400N(n) of the Code)**

### **Present Law**

#### **In general**

Under present law, gross income does not include interest on State or local bonds (sec. 103). State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes (“qualified private activity bonds”).

#### **Qualified private activity bonds**

The definition of a qualified private activity bond includes an exempt facility bond, or qualified mortgage, veterans’ mortgage, small issue, redevelopment, 501(c)(3), or student loan bond. 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.

Subject to certain requirements, qualified private activity bonds may be issued to finance residential rental property or owner-occupied housing. Residential rental property may be financed with exempt facility bonds if the financed project is a “qualified residential rental project.” A project is a qualified residential rental project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the “20-50 test”). Alternatively, a project is a qualified residential rental project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the “40-60 test”). The issuer must elect to apply either the 20-50 test or the 40-60 test. Operators of qualified residential rental projects must annually certify that such project meets the requirements for qualification, including meeting the 20-50 test or the 40-60 test.

### **Explanation of Provision**

Under the provision, the operator of a qualified residential rental project may rely on the representations of prospective tenants displaced by reason of Hurricane Katrina for purposes of determining whether such individual satisfies the income limitations for qualified residential rental projects and, thus, the project is in compliance with the 20-50 test or the 40-60 test. (For a description of modifications to the 20-50 test and the 40-60 test for qualified residential rental

projects financed in the GO Zone, see I.A.2. Tax-exempt financing for the Gulf Opportunity Zone, above).

This rule only applies if the individual's tenancy begins during the six-month period beginning on the date when such individual was displaced by Hurricane Katrina.

#### **Effective Date**

The provision is effective on the date of enactment.

### **17. Treatment of public utility disaster losses (new sec. 1400N(o) of the Code)**

#### **Present Law**

Under section 165(i), certain losses attributable to a disaster occurring in a Presidentially declared disaster area may, at the election of the taxpayer, be taken into account for the taxable year immediately preceding the taxable year in which the disaster occurred.

Section 6411 provides a procedure under which taxpayers may apply for tentative carryback and refund adjustments with respect to net operating losses, net capital losses, and unused business credits.

#### **Explanation of Provision**

The provision provides an election for taxpayers who incurred casualty losses attributable to Hurricane Katrina with respect to public utility property located in the Gulf Opportunity Zone. Under the election, such losses may be taken into account in the fifth taxable year (rather than the 1<sup>st</sup> taxable year) immediately preceding the taxable year in which the loss occurred. If the application of this provision results in the creation or increase of a net operating loss for the year in which the casualty loss is taken into account, the net operating loss may be carried back or carried over as under present law applicable to net operating losses for such year.

For this purpose, public utility property is property used predominantly in the trade or business of the furnishing or sale of electrical energy, water, or sewage disposal services; gas or steam through a local distribution system; telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962; or transportation of gas or steam by pipeline. Such property is eligible regardless of whether the taxpayer's rates are established or approved by any regulatory body.

A taxpayer making the election under the provision is eligible to file an application for a tentative carryback adjustment of the tax for any prior taxable year affected by the election. As under present law with respect to tentative carryback and refund adjustments, the IRS generally has 90 days to act on the refund claim. Under the provision, the statute of limitations with respect to such a claim can not expire earlier than one year after the date of enactment. Also, a taxpayer making the election with respect to a loss is not entitled to interest with respect to any overpayment attributable to the loss.

### **Effective Date**

The provision is effective for taxable years ending on or after August 28, 2005.

## **18. Tax benefits not available with respect to certain property (new sec. 1400N of the Code)**

### **Present Law**

Under present law, specific tax benefits do not apply with respect to certain types of property. For example, private activity bonds are subject to restrictions on the use of proceeds for the acquisition of land and existing property, use of proceeds to finance certain specified facilities (e.g., airplanes, skyboxes, other luxury boxes, health club facilities, gambling facilities, and liquor stores), and use of proceeds to pay costs of issuance (e.g., bond counsel and underwriter fees). Small issue and redevelopment bonds also are subject to additional restrictions on the use of proceeds for certain facilities (e.g., golf courses and massage parlors).

### **Explanation of Provision**

The provisions relating to additional first-year depreciation, increased expensing under section 179, and the five-year carryback of NOLs attributable to casualty losses, depreciation, or amortization otherwise provided under new Code section 1400N do not apply with respect to certain property. Specifically, the provisions do not apply with respect to any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. The provisions also do not apply with respect to any gambling or animal racing property.

For this purpose, gambling or animal racing property includes certain personal property and certain real property. Personal property treated as gambling or animal racing property is any equipment, furniture, software, or other property used directly in connection with gambling, the racing of animals, or the on-site (i.e., at the racetrack) viewing of such racing. Real property treated as gambling or animal racing property is the portion of any real property (determined by square footage) that is dedicated to gambling, the racing of animals, or the on-site viewing of such racing (except if the portion so dedicated is less than 100 square feet). For example, the additional first-year depreciation for a building which is used as both a casino and a hotel (and which otherwise qualifies for additional first-year depreciation under the bill) is determined without regard to the portion of the building's basis which bears the same percentage to the total basis as the percentage of square footage dedicated to gambling (i.e., the casino floor) bears to total square footage of the building.

No apportionment calculation is required with respect to real property which meets the 100-square-foot de minimis exception. Thus, for example, no apportionment calculation is required in the case of a retail store that sells lottery tickets in a less-than-100-square-foot area, nor in the case of an establishment that, while not a casino, contains a small number of gaming machines and devices in an area or areas whose aggregate size is less than 100 square feet.

### **Effective Date**

The provision is effective for taxable years ending on or after August 28, 2005, except that the inapplicability of the five-year carryback of NOLs attributable to casualty losses, depreciation, or amortization, is effective for losses arising in such years.

## **19. Expansion of Hope Scholarship and Lifetime Learning Credit for students in the Gulf Opportunity Zone (new sec. 1400O of the Code)**

### **Present Law**

#### **Hope credit**

The Hope credit (sec. 25A) is a nonrefundable credit of up to \$1,500 per student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program. The Hope credit rate is 100 percent on the first \$1,000 of qualified tuition and related expenses, and 50 percent on the next \$1,000 of qualified tuition and related expenses. The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between \$43,000 and \$53,000 (\$87,000 and \$107,000 for married taxpayers filing a joint return) for 2005. These adjusted gross income phase-out ranges are indexed for inflation. Also, each of the \$1,000 amounts of qualified tuition and related expenses to which the 100-percent credit rate and 50 percent credit rate apply are indexed for inflation, with the amount rounded down to the next lowest multiple of \$100. The first adjustment to these qualified expense amounts as a result of inflation is expected in 2006. The Hope credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2006.

The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The Hope credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year.

In addition, for each taxable year, a taxpayer may elect either the Hope credit, the Lifetime Learning credit (described below), or the deduction for qualified tuition and related expenses (sec. 222) with respect to an eligible student.

The Hope credit is available for "qualified tuition and related expenses," which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program. Total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year. The Hope credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

An eligible student for purposes of the Hope credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one half the normal full-time work load for the course of study the student is pursuing for at least one academic period that begins during the taxable year. To be eligible for the Hope credit, a student must not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

For taxable years beginning in 2004 and 2005, the Hope credit offsets the alternative minimum tax. For taxable years thereafter, the Hope credit does not offset the alternative minimum tax.

Effective for taxable years beginning after December 31, 2010, the changes to the Hope credit made by EGTRRA no longer apply. The EGTRRA change scheduled to expire is the change that permitted a taxpayer to claim a Hope credit in the same year that he or she claimed an exclusion from an education savings account. Thus, after 2010, a taxpayer cannot claim a Hope credit in the same year he or she claims an exclusion from an education savings account.

### **Lifetime Learning credit**

Individual taxpayers are allowed to claim a nonrefundable credit, the Lifetime Learning credit, equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents (Sec. 25A). Up to \$10,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return is \$2,000). In contrast with the Hope credit, the maximum credit amount is not indexed for inflation. The Lifetime Learning credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2006.

In contrast to the Hope credit, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the Hope credit, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return will not vary based on the number of students in the taxpayer's family -- that is, the Hope credit is computed on a per student basis, while the Lifetime Learning credit is computed on a family-wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between \$43,000 and \$53,000 (\$87,000 and \$107,000 for married taxpayers filing a joint return) for 2005. These phaseout ranges are the same as those for the Hope credit, and are similarly indexed for inflation.

A taxpayer may claim the Lifetime Learning credit for a taxable year with respect to one or more students, even though the taxpayer also claims a Hope credit for that same taxable year with respect to other students. If, for a taxable year, a taxpayer claims a Hope credit with respect to a student, then the Lifetime Learning credit is not available with respect to that same student for that year (although the Lifetime Learning credit may be available with respect to that same

student for other taxable years). As with the Hope credit, a taxpayer may not claim the Lifetime Learning credit and also claim the section 222 deduction for qualified tuition and related expenses (described below).

As with the Hope credit, the Lifetime Learning credit is available for “qualified tuition and related expenses,” which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of a student at the institution. Eligible higher education institutions are defined in the same manner for purposes of both the Hope and Lifetime Learning credits. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition expenses unless this education is part of the student’s degree program, or the education is undertaken to acquire or improve the job skills of the student.

In contrast to the Hope credit, qualified tuition and related expenses for purposes of the Lifetime Learning credit include tuition and fees incurred with respect to undergraduate or graduate-level courses (as explained above, the Hope credit is available only with respect to the first two years of a student’s undergraduate education). Additionally, in contrast to the Hope credit, the eligibility of a student for the Lifetime Learning credit does not depend on whether the student has been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

As under the Hope credit, total qualified tuition and fees are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student during the taxable year (such as employer-provided educational assistance excludable under section 127). The Lifetime Learning credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

For taxable years beginning in 2004 and 2005, the Lifetime Learning credit offsets the alternative minimum tax. For taxable years thereafter, the credit does not offset the alternative minimum tax.

Effective for taxable years beginning after December 31, 2010, the changes to the Lifetime Learning credit made by EGTRRA no longer apply. The EGTRRA change scheduled to expire is the change that permitted a taxpayer to claim a Lifetime Learning credit in the same year that he or she claimed an exclusion from an education savings account. Thus, after 2010, taxpayers cannot claim a Lifetime Learning credit in the same year he or she claims an exclusion from an education savings account.

### **Definition of qualified higher education expenses for purposes of qualified tuition programs**

Present law provides favorable tax treatment for qualified tuition programs that meet the requirements of section 529 of the Code. For purposes of the rules relating to qualified tuition programs, “qualified higher education expenses” means tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution and

expenses for special needs services in the case of a special needs beneficiary which are incurred in connection with such enrollment or attendance. In addition, in the case of at least half-time students, qualified higher education expenses include certain room and board expenses.

### **Explanation of Provision**

The provision temporarily expands the Hope and Lifetime Learning credits for students attending (i.e., enrolled and paying tuition at) an eligible education institution located in the Gulf Opportunity Zone.

Under the provision, the Hope credit is increased to 100 percent of the first \$2,000 in qualified tuition and related expenses and 50 percent of the next \$2,000 of qualified tuition and related expenses for a maximum credit of \$3,000 per student. The Lifetime Learning credit rate is increased from 20 percent to 40 percent. The provision expands the definition of qualified expenses to mean qualified higher education expenses as defined under the rules relating to qualified tuition programs, including certain room and board expenses for at least half-time students.

The provision applies to taxable years beginning in 2005 or 2006.

### **Effective Date**

The provision is effective on the date of enactment.

## **20. Housing relief for individuals affected by Hurricane Katrina (new sec. 1400P of the Code)**

### **Present Law**

Under present law, employer-provided housing is generally includible in income as compensation and is wages for purposes of social security and Medicare taxes and unemployment tax (secs. 61, 3121(a), 3306(b)). Present law provides an income and wage exclusion for the value of lodging furnished to an employee, the employee's spouse, or the employee's dependents by or on behalf of the employee's employer, but generally only if the employee is required to accept the lodging on the business premises of the employer as a condition of employment (secs. 119, 3121(a)(19), and 3306(b)(14)). Reasonable expenses for employee compensation are deductible by the employer (sec. 162(a)).

### **Explanation of Provision**

The provision provides a temporary income exclusion for the value of in-kind lodging provided for a month to a qualified employee (and the employee's spouse or dependents) by or on behalf of a qualified employer. The amount of the exclusion for any month for which lodging is furnished cannot exceed \$600. The exclusion does not apply for purposes of social security and Medicare taxes or unemployment tax.

The provision also provides a temporary credit to a qualified employer of 30 percent of the value of lodging excluded from the income of a qualified employee under the provision. The amount taken as a credit is not deductible by the employer.

Qualified employee means, with respect to a month, an individual who: (1) on August 28, 2005, had a principal residence in the Gulf Opportunity (“GO”) Zone; and (2) performs substantially all of his or her employment services in the GO Zone for the qualified employer furnishing the lodging. Qualified employer means any employer with a trade or business located in the GO Zone.

### **Effective Date**

The provision applies to lodging provided during the period beginning on the first day of the first month beginning after the date of enactment and ending on the date that is six months after such first day.

## **21. Special rules for mortgage revenue bonds (sec. 404 of the Katrina Emergency Tax Relief Act of 2005)**

### **Present Law**

#### **In general**

Under present law, gross income does not include interest on State or local bonds (sec. 103). State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes (“qualified private activity bonds”) (secs. 103(b)(1) and 141).

#### **Qualified mortgage bonds**

The definition of a qualified private activity bond includes a qualified mortgage bond (sec. 143). Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for eligible mortgagors, purchase price limitations on the home financed with bond proceeds, and a “first-time homebuyer” requirement. The income limitations are satisfied if all financing provided by an issue is provided for mortgagors whose family income does not exceed 115 percent of the median family income for the metropolitan area or State, whichever is greater, in which the financed residences are located. The purchase price limitations provide that a residence financed with qualified mortgage bonds may not have a purchase price in excess of 90 percent of the average area purchase price for that residence. The first-time homebuyer requirement provides qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the “first-time homebuyer” requirement).

Special income and purchase price limitations apply to targeted area residences. A targeted area residence is one located in either (1) a census tract in which at least 70 percent of the families have an income which is 80 percent or less of the state-wide median income or (2) an area of chronic economic distress. For targeted area residences, the income limitation is satisfied when no more than one-third of the mortgages are made without regard to any income limits and the remainder of the mortgages are made to mortgagors whose family income is 140 percent or less of the applicable median family income. The purchase price limitation is raised from 90 percent to 110 percent of the average area purchase price for targeted area residences. In addition, the first-time homebuyer requirement does not apply to targeted area residences.

Qualified mortgage bonds also may be used to finance qualified home-improvement loans. Qualified home-improvement loans are defined as loans to finance alterations, repairs, and improvements on an existing residence, but only if such alterations, repairs, and improvements substantially protect or improve the basic livability or energy efficiency of the property. Qualified home-improvement loans may not exceed \$15,000.

A temporary provision waived the first-time homebuyer requirement for residences located in certain Presidentially declared disaster areas (sec. 143(k)(11)). In addition, residences located in such areas were treated as targeted area residences for purposes of the income and purchase price limitations. The special rule for residences located in Presidentially declared disaster areas does not apply to bonds issued after January 1, 1999.

The Katrina Emergency Tax Relief Act (“KETRA”) waives the first-time homebuyer requirement with respect to certain residences located in an area with respect to which a major disaster has been declared by the President before September 14, 2005, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina (see sec. 404 of Pub. L. No. 109-73). The waiver of the first-time homebuyer requirement does not apply to financing provided after December 31, 2007. KETRA also increases to \$150,000 the permitted amount of a qualified home-improvement loans with respect to residences located in the Hurricane Katrina disaster area to the extent such loan is for the repair of damage caused by Hurricane Katrina.

### **Explanation of Provision**

The proposal extends the waiver of the first-time homebuyer requirement provided by KETRA to financing provided through December 31, 2010.

(For a description of additional mortgage revenue bond rules applicable to the GO Zone, the Rita GO Zone and the Wilma GO Zone, see II.H - Special Rules for Mortgage Revenue Bonds, below)

### **Effective Date**

The provision is effective on the date of enactment.

## **22. Treasury authority to grant bonus depreciation placed-in-service date relief (sec. 168(k) of the Code)**

### **Present Law**

#### **In general**

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

#### **Additional first year depreciation deduction**

Sec. 168(k) allows an additional first-year depreciation deduction equal to 30 percent or 50 percent of the adjusted basis of qualified property. 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 (1) property to which MACRS applies with an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) computer software other than computer software covered by section 197, or (4) qualified leasehold improvement property (as defined in section 168(k)(3)). Second, the original use (the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer) of the property must commence with the taxpayer on or after September 11, 2001. Third, the taxpayer must acquire the property within the applicable time period. Finally, the property must be placed in service before January 1, 2005.

An extension of the placed-in-service date of one year (i.e., January 1, 2006) is provided for certain property with a recovery period of ten years or longer and certain transportation property. In order for property to qualify for the extended placed-in-service date, the property must be subject to section 263A and have an estimated production period exceeding two years or an estimated production period exceeding one year and a cost exceeding \$1 million. Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is (1) after September 10, 2001 and before January 1, 2005, but only if no binding written contract for the acquisition is in effect before September 11, 2001, or (2) pursuant to a binding written contract which was entered into after September 10, 2001, and before January 1, 2005. With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after September 10, 2001. For property eligible for the extended placed-in-service date, a special rule limits the amount of costs eligible for the additional first year depreciation. With respect to such property,

only the portion of the basis that is properly attributable to the costs incurred before January 1, 2005 (“progress expenditures”) is eligible for the additional first-year depreciation. For purposes of determining the amount of eligible progress expenditures, rules similar to sec. 46(d)(3) as in effect prior to the Tax Reform Act of 1986 apply.

In addition, certain non-commercial aircraft can qualify for the extended placed-in-service date. Qualifying aircraft are eligible for the additional first-year depreciation deduction if placed in service before January 1, 2006. In order to qualify, the aircraft must:

1. be acquired by the taxpayer during the applicable time period as under present law;
2. meet the appropriate placed-in-service date requirements;
3. not be tangible personal property used in the trade or business of transporting persons or property (except for agricultural or firefighting purposes);
4. be purchased by a purchaser who, at the time of the contract for purchase, has made a nonrefundable deposit of the lesser of ten percent of the cost or \$100,000; and
5. have an estimated production period exceeding four months and a cost exceeding \$200,000.

Aircraft qualifying under these rules are not subject to the progress expenditures limitation.

#### **Explanation of Provision**

The provision provides the Secretary with authority to further extend the placed-in-service date (beyond December 31, 2005), on a case-by-case basis, for certain property eligible for the December 31, 2005 placed-in-service date under present law. The authority extends only to property placed in service or manufactured in the Gulf Opportunity Zone, the Rita GO Zone, or the Wilma GO Zone. In addition, the authority extends only to circumstances in which the taxpayer was unable to meet the December 31, 2005 deadline as a result of Hurricanes Katrina, Rita, and/or Wilma. The extension should be only for such additional time as is required as a result of the hurricane(s) and in no case should extend the deadline beyond December 31, 2006.

#### **Effective Date**

The provision applies to property placed in service on or after August 28, 2005, in taxable years ending on or after such date.

## **TITLE II – TAX BENEFITS RELATED TO HURRICANES RITA AND WILMA**

### **A. Special Rules for Use of Retirement Funds (new Code sec. 1400Q)**

#### **1. Tax-favored withdrawals from retirement plans relating to Hurricanes Rita and Wilma**

##### **Present Law**

##### **In general**

Under present law, a distribution from a qualified retirement plan under section 401(a), a qualified annuity plan under section 403(a), a tax-sheltered annuity under section 403(b) (a “403(b) annuity”), an eligible deferred compensation plan maintained by a State or local government under section 457 (a “governmental 457 plan”), or an individual retirement arrangement under section 408 (an “IRA”) generally is included in income for the year distributed (secs. 402(a), 403(a), 403(b), 408(d), and 457(a)). (These plans are referred to collectively as “eligible retirement plans”.) In addition, a distribution from a qualified retirement or annuity plan, a 403(b) annuity, or an IRA received before age 59-½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception applies (sec. 72(t)).

An eligible rollover distribution from a qualified retirement or annuity plan, a 403(b) annuity, or a governmental 457 plan, or a distribution from an IRA, generally can be rolled over within 60 days to another plan, annuity, or IRA. The IRS has the authority to waive the 60-day requirement if failure to waive the requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual. Any amount rolled over is not includible in income (and thus also not subject to the 10-percent early withdrawal tax).

Distributions from a qualified retirement or annuity plan, 403(b) annuity, a governmental 457 plan, or an IRA are generally subject to income tax withholding unless the recipient elects otherwise. An eligible rollover distribution from a qualified retirement or annuity plan, 403(b) annuity, or governmental 457 plan is subject to income tax withholding at a 20-percent rate unless the distribution is rolled over to another plan, annuity or IRA by means of a direct transfer.

Certain amounts held in a qualified retirement plan that includes a qualified cash-or-deferred arrangement (a “401(k) plan”) or in a 403(b) annuity may not be distributed before severance from employment, age 59-½, death, disability, or financial hardship of the employee. Amounts deferred under a governmental 457 plan may not be distributed before severance from employment, age 70-½, or an unforeseeable emergency of the employee.

##### **Katrina Emergency Tax Relief Act of 2005**

The Katrina Emergency Tax Relief Act of 2005 (Public Law 109-73) provides an exception to the 10-percent early withdrawal tax in the case of a qualified Hurricane Katrina

distribution from a qualified retirement or annuity plan, a 403(b) annuity, or an IRA. In addition, as discussed more fully below, income attributable to a qualified Hurricane Katrina distribution may be included in income ratably over three years, and the amount of a qualified Hurricane Katrina distribution may be recontributed to an eligible retirement plan within three years.

A qualified Hurricane Katrina distribution is a distribution from an eligible retirement plan made on or after August 25, 2005, and before January 1, 2007, to an individual whose principal place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area and who has sustained an economic loss by reason of Hurricane Katrina. The total amount of qualified Hurricane Katrina distributions that an individual can receive from all plans, annuities, or IRAs is \$100,000. Thus, any distributions in excess of \$100,000 during the applicable period are not qualified Hurricane Katrina distributions.

Any amount required to be included in income as a result of a qualified Hurricane Katrina distribution is included in income ratably over the three-year period beginning with the year of distribution unless the individual elects not to have ratable inclusion apply. Certain rules apply for purposes of the ratable inclusion provision. For example, the amount required to be included in income for any taxable year in the three-year period cannot exceed the total amount to be included in income with respect to the qualified Hurricane Katrina distribution, reduced by amounts included in income for preceding years in the period.

Any portion of a qualified Hurricane Katrina distribution may, at any time during the three-year period beginning the day after the date on which the distribution was received, be recontributed to an eligible retirement plan to which a rollover can be made. Any amount recontributed within the three-year period is treated as a rollover and thus is not includible in income. For example, if an individual receives a qualified Hurricane Katrina distribution in 2005, that amount is included in income, generally ratably over the year of the distribution and the following two years, but is not subject to the 10-percent early withdrawal tax. If, in 2007, the amount of the qualified Hurricane Katrina distribution is recontributed to an eligible retirement plan, the individual may file an amended return (or returns) to claim a refund of the tax attributable to the amount previously included in income. In addition, if, under the ratable inclusion provision, a portion of the distribution has not yet been included in income at the time of the contribution, the remaining amount is not includible in income.

A qualified Hurricane Katrina distribution is a permissible distribution from a 401(k) plan, 403(b) annuity, or governmental 457 plan, regardless of whether a distribution would otherwise be permissible. A plan is not treated as violating any Code requirement merely because it treats a distribution as a qualified Hurricane Katrina distribution, provided that the aggregate amount of such distributions from plans maintained by the employer and members of the employer's controlled group does not exceed \$100,000. Thus, a plan is not treated as violating any Code requirement merely because an individual might receive total distributions in excess of \$100,000, taking into account distributions from plans of other employers or IRAs.

Qualified Hurricane Katrina distributions are subject to the income tax withholding rules applicable to distributions other than eligible rollover distributions. Thus, 20-percent mandatory withholding does not apply.

## **Explanation of Provision**

The provision codifies and expands the relief provided under the Katrina Emergency Tax Relief Act of 2005 in the case of qualified Hurricane Katrina distributions to any “qualified hurricane distribution,” which is defined to include distributions relating to Hurricanes Rita and Wilma. Under the provision, a qualified hurricane distribution includes distributions that meet the definition of qualified Hurricane Katrina distribution under the Katrina Emergency Tax Relief Act of 2005, as well as any other distribution from an eligible retirement plan made on or after September 23, 2005, and before January 1, 2007, to an individual whose principal place of abode on September 23, 2005, is located in the Hurricane Rita disaster area and who has sustained an economic loss by reason of Hurricane Rita. A qualified hurricane distribution also includes a distribution from an eligible retirement plan made on or after October 23, 2005, and before January 1, 2007, to an individual whose principal place of abode on October 23, 2005, is located in the Hurricane Wilma disaster area and who has sustained an economic loss by reason of Hurricane Wilma.

The total amount of qualified hurricane distributions that an individual can receive from all plans, annuities, or IRAs is \$100,000.

## **Effective Date**

The provision is effective on the date of enactment.

## **2. Recontributions of withdrawals for home purchases cancelled due to Hurricanes Rita and Wilma**

### **Present Law**

#### **In general**

Under present law, a distribution from a qualified retirement plan, a tax-sheltered annuity (a “403(b) annuity”), or an individual retirement arrangement (an “IRA”) generally is included in income for the year distributed (secs. 402(a), 403(b), and 408(d)). In addition, a distribution from a qualified retirement plan, a 403(b) annuity, or an IRA received before age 59-½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception applies (sec. 72(t)). An exception to the 10-percent tax applies in the case of a qualified first-time homebuyer distribution from an IRA, i.e., a distribution (not to exceed \$10,000) used within 120 days for the purchase or construction of a principal residence of a first-time homebuyer.

An eligible rollover distribution from a qualified retirement plan or a 403(b) annuity or a distribution from an IRA generally can be rolled over within 60 days to another plan, annuity, or IRA. The IRS has the authority to waive the 60-day requirement if failure to waive the requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual. Any amount rolled over is not includible in income (and thus also not subject to the 10-percent early withdrawal tax).

Certain amounts held in a qualified retirement plan that includes a qualified cash-or-deferred arrangement (a “401(k) plan”) or a 403(b) annuity may not be distributed before severance from employment, age 59-½, death, disability, or financial hardship of the employee. For this purpose, subject to certain conditions, distributions for costs directly related to the purchase of a principal residence by an employee (excluding mortgage payments) are deemed to be distributions on account of financial hardship.

### **Katrina Emergency Tax Relief Act of 2005**

The Katrina Emergency Tax Relief Act of 2005 generally provides that a distribution received from a 401(k) plan, 403(b) annuity, or IRA in order to purchase a home in the Hurricane Katrina disaster area may be recontributed to such a plan, annuity, or IRA in certain circumstances.

The ability to recontribute applies to an individual who receives a qualified distribution. A qualified distribution is a hardship distribution from a 401(k) plan or 403(b) annuity, or a qualified first-time homebuyer distribution from an IRA: (1) that is received after February 28, 2005, and before August 29, 2005; and (2) that was to be used to purchase or construct a principal residence in the Hurricane Katrina disaster area, but the residence is not purchased or constructed on account of Hurricane Katrina.

Any portion of a qualified distribution may, during the period beginning on August 25, 2005, and ending on February 28, 2006, be recontributed to a plan, annuity or IRA to which a rollover is permitted. Any amount recontributed is treated as a rollover. Thus, that portion of the qualified distribution is not includible in income (and also is not subject to the 10-percent early withdrawal tax).

### **Explanation of Provision**

The provision codifies and expands the provision under the Katrina Emergency Tax Relief Act of 2005 allowing recontribution of certain distributions from a 401(k) plan, 403(b) annuity, or IRA to qualified Hurricane Rita distributions and to qualified Hurricane Wilma distributions.

A qualified Hurricane Rita distribution is a hardship distribution from a 401(k) plan or 403(b) annuity, or a qualified first-time homebuyer distribution from an IRA: (1) that is received after February 28, 2005, and before September 24, 2005; and (2) that was to be used to purchase or construct a principal residence in the Hurricane Rita disaster area, but the residence is not purchased or constructed on account of Hurricane Rita. Any portion of a qualified Hurricane Rita distribution may, during the period beginning on September 23, 2005, and ending on February 28, 2006, be recontributed to a plan, annuity or IRA to which a rollover is permitted.

A qualified Hurricane Wilma distribution is a hardship distribution from a 401(k) plan or 403(b) annuity, or a qualified first-time homebuyer distribution from an IRA: (1) that is received after February 28, 2005, and before October 24, 2005; and (2) that was to be used to purchase or construct a principal residence in the Hurricane Wilma disaster area, but the residence is not purchased or constructed on account of Hurricane Wilma. Any portion of a qualified Hurricane

Wilma distribution may, during the period beginning on October 23, 2005, and ending on February 28, 2006, be recontributed to a plan, annuity or IRA to which a rollover is permitted.

### **Effective Date**

The provision is effective on the date of enactment.

### **3. Loans from qualified plans to individuals sustaining an economic loss due to Hurricane Rita or Wilma**

#### **Present Law**

##### **In general**

An individual is permitted to borrow from a qualified plan in which the individual participates (and to use his or her accrued benefit as security for the loan) provided the loan bears a reasonable rate of interest, is adequately secured, provides a reasonable repayment schedule, and is not made available on a basis that discriminates in favor of employees who are officers, shareholders, or highly compensated.

Subject to certain exceptions, a loan from a qualified employer plan to a plan participant is treated as a taxable distribution of plan benefits. A qualified employer plan includes a qualified retirement plan under section 401(a), a qualified annuity plan under section 403(a), a tax-deferred annuity under section 403(b), and any plan that was (or was determined to be) a qualified employer plan or a governmental plan.

An exception to this general rule of income inclusion is provided to the extent that the loan (when added to the outstanding balance of all other loans to the participant from all plans maintained by the employer) does not exceed the lesser of (1) \$50,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made or (2) the greater of \$10,000 or one half of the participant's accrued benefit under the plan (sec. 72(p)). This exception applies only if the loan is required, by its terms, to be repaid within five years. An extended repayment period is permitted for the purchase of the principal residence of the participant. Plan loan repayments (principal and interest) must be amortized in level payments and made not less frequently than quarterly, over the term of the loan.

#### **Katrina Emergency Tax Relief Act of 2005**

The Katrina Emergency Tax Relief Act of 2005 provides special rules in the case of a loan from a qualified employer plan to a qualified individual made after September 23, 2005, and before January 1, 2007. A qualified individual is an individual whose principal place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area and who has sustained an economic loss by reason of Hurricane Katrina.

The exception to the general rule of income inclusion is provided to the extent that the loan (when added to the outstanding balance of all other loans to the participant from all plans

maintained by the employer) does not exceed the lesser of (1) \$100,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made or (2) the greater of \$10,000 or the participant's accrued benefit under the plan.

In the case of a qualified individual with an outstanding loan on or after August 25, 2005, from a qualified employer plan, if the due date for any repayment with respect to such loan occurs during the period beginning on August 25, 2005, and ending on December 31, 2006, such due date is delayed for one year. Any subsequent repayments with respect to such loan shall be appropriately adjusted to reflect the delay in the due date and any interest accruing during such delay. The period during which required repayment is delayed is disregarded in complying with the requirements that the loan be repaid within five years and that level amortization payments be made.

### **Explanation of Provision**

The provision codifies and expands the special rules for loans from a qualified employer plan provided under the Katrina Emergency Tax Relief Act of 2005 to loans from a qualified employer plan to a qualified Hurricane Rita or Hurricane Wilma individual made on or after the date of enactment and before January 1, 2007.

A qualified Hurricane Rita individual includes an individual whose principal place of abode on September 23, 2005, is located in a Hurricane Rita disaster area and who has sustained an economic loss by reason of Hurricane Rita. In the case of a qualified Hurricane Rita individual with an outstanding loan on or after September 23, 2005, from a qualified employer plan, if the due date for any repayment with respect to such loan occurs during the period beginning on September 23, 2005, and ending on December 31, 2006, such due date is delayed for one year.

A qualified Hurricane Wilma individual includes an individual whose principal place of abode on October 23, 2005, is located in a Hurricane Wilma disaster area and who has sustained an economic loss by reason of Hurricane Wilma. In the case of a qualified Hurricane Wilma individual with an outstanding loan on or after October 23, 2005, from a qualified employer plan, if the due date for any repayment with respect to such loan occurs during the period beginning on October 23, 2005, and ending on December 31, 2006, such due date is delayed for one year.

An individual cannot be a qualified individual with respect to more than one hurricane.

### **Effective Date**

The provision is effective on the date of enactment.

#### **4. Plan amendments relating to Hurricane Rita and Hurricane Wilma relief**

##### **Present Law**

##### **In general**

Present law provides a remedial amendment period during which, under certain circumstances, a plan may be amended retroactively in order to comply with the qualification requirements (sec. 401(b)). In general, plan amendments to reflect changes in the law generally must be made by the time prescribed by law for filing the income tax return of the employer for the employer's taxable year in which the change in law occurs. The Secretary of the Treasury may extend the time by which plan amendments need to be made.

##### **Katrina Emergency Tax Relief Act of 2005**

The Katrina Emergency Tax Relief Act of 2005 permits certain plan amendments made pursuant to the changes made by the provisions of Title I of the Act, or regulations issued thereunder, to be retroactively effective. If the plan amendment meets the requirements of the Act, then the plan will be treated as being operated in accordance with its terms. In order for this treatment to apply, the plan amendment is required to be made on or before the last day of the first plan year beginning on or after January 1, 2007, or such later date as provided by the Secretary of the Treasury. Governmental plans are given an additional two years in which to make required plan amendments. If the amendment is required to be made to retain qualified status as a result of the changes made by Title I of the Act (or regulations), the amendment is required to be made retroactively effective as of the date on which the change became effective with respect to the plan, and the plan is required to be operated in compliance until the amendment is made. Amendments that are not required to retain qualified status but that are made pursuant to the changes made by Title I of the Act (or regulations) may be made retroactively effective as of the first day the plan is operated in accordance with the amendment. A plan amendment will not be considered to be pursuant to changes made by Title I of the Act (or regulations) if it has an effective date before the effective date of the provision under the Act (or regulations) to which it relates.

##### **Explanation of Provision**

The provision codifies and expands the ability to make retroactive plan amendments under the Katrina Emergency Tax Relief Act of 2005 to apply to changes made pursuant to new section 1400Q of the Code, or regulations issued thereunder.

##### **Effective Date**

The provision is effective on the date of enactment.

**B. Employee Retention Credit for Employers Affected by Hurricanes Katrina,  
Rita and Wilma  
(new sec. 1400R of the Code)**

**Present Law**

The Katrina Emergency Tax Relief Act of 2005 provides a credit of 40 percent of the qualified wages (up to a maximum of \$6,000 in qualified wages per employee) paid by an eligible employer to an eligible employee.

An eligible employer is any employer (1) that conducted an active trade or business on August 28, 2005, in the core disaster area and (2) with respect to which the trade or business described in (1) is inoperable on any day after August 28, 2005, and before January 1, 2006, as a result of damage sustained by reason of Hurricane Katrina. An eligible employer shall not include any trade or business for any taxable year if such trade or business employed an average of more than 200 employees on business days during the taxable year.

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

An eligible employee is, with respect to an eligible employer, an employee whose principal place of employment on August 28, 2005, with such eligible employer was in a core disaster area. An employee may not be treated as an eligible employee for any period with respect to an employer if such employer is allowed a credit under section 51 with respect to the employee for the period.

Qualified wages are wages (as defined in section 51(c)(1) of the Code, but without regard to section 3306(b)(2)(B) of the Code) paid or incurred by an eligible employer with respect to an eligible employee on any day after August 28, 2005, and before January 1, 2006, during the period (1) beginning on the date on which the trade or business first became inoperable at the principal place of employment of the employee immediately before Hurricane Katrina, and (2) ending on the date on which such trade or business has resumed significant operations at such principal place of employment. Qualified wages include wages paid without regard to whether the employee performs no services, performs services at a different place of employment than such principal place of employment, or performs services at such principal place of employment before significant operations have resumed.

The credit is a part of the current year business credit under section 38(b) and therefore is subject to the tax liability limitations of section 38(c). Rules similar to sections 280C(a), 51(i)(1) and 52 apply to the credit.

### **Explanation of Provision**

The provision codifies the employee retention credit provisions that were enacted in the Katrina Emergency Tax Relief Act of 2005, and eliminates the provision that restricted the credit to employers of not more than 200 employees.

The provision extends the retention credit, as modified to eliminate the employer size limitation, to employers affected by Hurricanes Rita and Wilma and located in the Rita GO Zone and Wilma GO Zone, respectively. The reference dates for employers affected by Hurricane Rita and Hurricane Wilma, comparable to the August 28, 2005 date of present law for employers affected by Hurricane Katrina, are September 23, 2005, and October 23, 2005, respectively.

### **Effective Date**

The codification of the provision in the Katrina Emergency Tax Relief Act of 2005 takes effect on the date of enactment. The provision that repeals the employer size limitation is, with respect to the Hurricane Katrina retention credit, effective as if included in the Katrina Emergency Tax Relief Act of 2005. The retention credit is effective for wages paid after September 23, 2005 in the case of Hurricane Rita and after October 23, 2005 in the case of Hurricane Wilma.

## **C. Temporary Suspension of Limitations on Charitable Contributions (new sec. 1400S(a) of the Code)**

### **Present Law**

#### **In general**

In general, an income tax deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization (sec. 170).

Charitable contributions of cash are deductible in the amount contributed. In general, contributions of capital gain property to a qualified charity are deductible at fair market value with certain exceptions. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of other appreciated property generally are deductible at the donor's basis in the property. Contributions of depreciated property generally are deductible at the fair market value of the property.

#### **Percentage limitations**

##### **Contributions by individuals**

For individuals, in any taxable year, the amount deductible as a charitable contribution is limited to a percentage of the taxpayer's contribution base. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. The contribution base is defined as the taxpayer's adjusted gross income computed without regard to any net operating loss carryback.

Contributions by an individual taxpayer of property (other than appreciated capital gain property) to a charitable organization described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) may not exceed 50 percent of the taxpayer's contribution base. Contributions of this type of property to nonoperating private foundations and certain other organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

Contributions of appreciated capital gain property to charitable organizations described in section 170(b)(1)(A) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of appreciated capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of appreciated capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private nonoperating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

### Contributions by corporations

For corporations, in any taxable year, charitable contributions are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating loss or capital loss carrybacks.

For purposes of determining whether a corporation's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions.

### Carryforward of excess contributions

Charitable contributions that exceed the applicable percentage limitation may be carried forward for up to five years (sec. 170(d)). The amount that may be carried forward from a taxable year ("contribution year") to a succeeding taxable year may not exceed the applicable percentage of the contribution base for the succeeding taxable year less the sum of contributions made in the succeeding taxable year plus contributions made in taxable years prior to the contribution year and treated as paid in the succeeding taxable year under this provision.

### **Overall limitation on itemized deductions ("Pease" limitation)**

Under present law, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is reduced by three percent of the amount of the taxpayer's adjusted gross income in excess of a certain threshold. The otherwise allowable itemized deductions may not be reduced by more than 80 percent. For 2005, the adjusted gross income threshold is \$145,950 (\$72,975 for a married taxpayer filing a joint return). These dollar amounts are adjusted for inflation.

The otherwise applicable overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation is repealed for taxable years beginning after December 31, 2009, and reinstated for taxable years beginning after December 31, 2010.

### **Katrina Emergency Tax Relief Act of 2005—Increase in percentage limitations**

Under section 301 of the Katrina Emergency Tax Relief Act of 2005, in the case of an individual, the deduction for qualified contributions is allowed up to the amount by which the taxpayer's contribution base exceeds the deduction for other charitable contributions. Contributions in excess of this amount are carried over to succeeding taxable years as contributions described in 170(b)(1)(A), subject to the limitations of section 170(d)(1)(A)(i) and (ii).

In the case of a corporation, the deduction for qualified contributions is allowed up to the amount by which the corporation's taxable income (as computed under section 170(b)(2)) exceeds the deduction for other charitable contributions. Contributions in excess of this amount are carried over to succeeding taxable years, subject to the limitations of section 170(d)(2).

In applying subsections (b) and (d) of section 170 to determine the deduction for other contributions, qualified contributions are not taken into account (except to the extent qualified contributions are carried over to succeeding taxable years under the rules described above).

Qualified contributions are cash contributions made during the period beginning on August 28, 2005, and ending on December 31, 2005, to a charitable organization described in section 170(b)(1)(A) (other than a supporting organization described in section 509(a)(3)). Contributions of noncash property, such as securities, are not qualified contributions. Under the provision, qualified contributions must be to an organization described in section 170(b)(1)(A); thus, contributions to, for example, a charitable remainder trust generally are not qualified contributions, unless the charitable remainder interest is paid in cash to an eligible charity during the applicable time period. In the case of a corporation, qualified contributions must be for relief efforts related to Hurricane Katrina. A taxpayer must elect to have the contributions treated as qualified contributions.

Qualified contributions do not include a contribution if the contribution is for establishment of a new, or maintenance in an existing, segregated fund or account with respect to which the donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to distributions or investments by reason of the donor's status as a donor. For example, a segregated fund or account exists if a donor makes a charitable contribution and the donee separately identifies the donor's contribution on its books. The donor has advisory privileges with respect to such segregated fund or account if the donor, by written agreement or otherwise, reasonably expects to provide advice to the donee as to the investment or distribution of amounts from such fund or account. In addition, a segregated fund or account also includes, but is not limited to, a separate bank account or trust established or maintained by a donee; however, in order for a contribution to such account or fund necessarily to be not a qualified contribution, the donor (or a person appointed or designated by the donor) must have or reasonably expect to have advisory privileges as to the investment or distribution of amounts in such account or fund. For instance, a donor reasonably expects to have advisory privileges with respect to contributions made by the donor if the donor understands that the donee will consider advice provided by the donor (or a person appointed or designated by the donor) in making investments or distributions. It is intended that a person shall not be treated as having advisory privileges by virtue of having a legal or contractual right or obligation, or a fiduciary duty, with respect to a segregated fund or account. If a donor makes a contribution for establishment of a new, or maintenance in an existing segregated account or fund, and the donor also provides advice with respect to amounts in such account or fund by reason of the donor's position as an officer, employee, or director of the donee, and not by reason of the donor's status as a donor, then, under the provision, the donor is not treated as having or reasonably expecting to have advisory privileges with respect to such fund or account. However, if by reason of a donor's charitable contribution to a segregated account or fund, the donor secured an appointment on a committee of the donee organization that advised how to distribute or invest amounts in such account or fund, the contribution would not be a qualified contribution notwithstanding that the donor is an officer, employee, or director of the donee organization.

The Act requires that qualified contributions by a corporation be made for relief efforts related to Hurricane Katrina. Corporate taxpayers must substantiate that the contribution is made for this purpose.

### **Limitation on overall itemized deductions**

Under the Katrina Emergency Tax Relief Act of 2005, the charitable contribution deduction up to the amount of qualified contributions (as defined above) paid during the year is not treated as an itemized deduction for purposes of the overall limitation on itemized deductions.

### **Explanation of Provision**

The provision codifies the provisions in the Katrina Emergency Tax Relief Act of 2005, and extends the definition of qualified contributions (as described above), in the case of corporations, to include contributions for relief efforts related to Hurricane Rita and Hurricane Wilma.

### **Effective Date**

The codification of the provision in the Katrina Emergency Tax Relief Act of 2005 takes effect on date of enactment. The expansion of the provision applies to contributions made on or after September 23, 2005.

## **D. Suspension of Certain Limitations on Personal Casualty Losses (new section 1400S(b) of the Code)**

### **Present Law**

#### **In general**

Under present law, a taxpayer may generally claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise (sec. 165). For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft. Personal casualty or theft losses are deductible only if they exceed \$100 per casualty or theft. In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's adjusted gross income.

#### **Hurricane Katrina**

Under the Katrina Emergency Tax Relief Act of 2005, the two limitations on personal casualty or theft losses do not apply to the extent those losses arise in the Hurricane Katrina disaster area on or after August 25, 2005, and are attributable to Hurricane Katrina ("Katrina casualty losses"). Specifically, Katrina casualty losses meeting the above requirements need not exceed \$100 per casualty or theft. In addition, such losses are deductible without regard to whether aggregate net losses exceed 10 percent of a taxpayer's adjusted gross income. For purposes of applying the 10 percent threshold to other personal casualty or theft losses, Katrina casualty losses are disregarded. Thus, such losses are effectively treated as a deduction separate from all other casualty losses.

For purposes of determining whether a loss is a Katrina casualty loss, the term "Hurricane Katrina disaster area" means an area with respect to which a major disaster had been declared by the President before September 14, 2005, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina. The States for which such a disaster had been declared are Alabama, Florida, Louisiana, and Mississippi.

### **Explanation of Provision**

The provision codifies the Katrina Emergency Tax Relief Act of 2005 rule for Katrina casualty losses and expands it to include losses that arise in the Hurricane Rita disaster area and are attributable to Hurricane Rita and losses that arise in the Hurricane Wilma disaster area and are attributable to Hurricane Wilma.

### **Effective Date**

The codification of the provision in the Katrina Emergency Tax Relief Act of 2005 takes effect on date of enactment. The expansion of the provision applies to losses related to Hurricane Rita arising on or after September 23, 2005, and to losses related to Hurricane Wilma arising on or after October 23, 2005.

**E. Required Exercise of IRS Administrative Authority  
(new sec. 1400S(c) of the Code)**

**Present Law**

**General time limits for filing tax returns**

Individuals generally must file their Federal income tax returns by April 15 of the year following the close of a taxable year. The Secretary may grant reasonable extensions of time for filing such returns. Treasury regulations provide an additional automatic two-month extension (until June 15 for calendar-year individuals) for United States citizens and residents in military or naval service on duty on April 15 of the following year (the otherwise applicable due date of the return) outside the United States. No action is necessary to apply for this extension, but taxpayers must indicate on their returns (when filed) that they are claiming this extension. Unlike most extensions of time to file, this extension applies to both filing returns and paying the tax due.

Treasury regulations also provide, upon application on the proper form, an automatic four-month extension (until August 15 for calendar-year individuals) for any individual timely filing that form and paying the amount of tax estimated to be due.

In general, individuals must make quarterly estimated tax payments by April 15, June 15, September 15, and January 15 of the following taxable year. Wage withholding is considered to be a payment of estimated taxes

**Suspension of time periods**

In general, the period of time for performing various acts under the Code, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, is suspended for any individual serving in the Armed Forces of the United States in an area designated as a “combat zone” or when deployed outside the United States away from the individual’s permanent duty station while participating in an operation designated by the Secretary of Defense as a “contingency operation” or that becomes a contingency operation. The suspension of time also applies to an individual serving in support of such Armed Forces in the combat zone or contingency operation, such as Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those Forces. The designation of a combat zone must be made by the President in an Executive Order. A contingency operation is defined as a military operation that is designated by the Secretary of Defense as an operation in which members of the Armed Forces are or may become involved in military actions, operations, or hostilities against an enemy of the United States or against an opposing military force, or results in the call or order to (or retention of) active duty of members of the uniformed services during a war or a national emergency declared by the President or Congress.

The suspension of time encompasses the period of service in the combat zone during the period of combatant activities in the zone or while participating in a contingency operation, as well as (1) any time of continuous qualified hospitalization resulting from injury received in the

combat zone or contingency operation or (2) time in missing in action status, plus the next 180 days.

The suspension of time applies to the following acts:

1. Filing any return of income, estate, gift, employment or excise taxes;
2. Payment of any income, estate, gift, employment or excise taxes;
3. Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court;
4. Allowance of a credit or refund of any tax;
5. Filing a claim for credit or refund of any tax;
6. Bringing suit upon any such claim for credit or refund;
7. Assessment of any tax;
8. Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;
9. Collection of the amount of any liability in respect of any tax;
10. Bringing suit by the United States in respect of any liability in respect of any tax; and
11. Any other act required or permitted under the internal revenue laws specified by the Secretary of the Treasury.

In the case of a Presidentially declared disaster or a terroristic or military action, the Secretary of the Treasury also has authority to prescribe a period of up to one year that may be disregarded for performing any of the acts listed above. The Secretary also may suspend the accrual of any interest, penalty, additional amount, or addition to tax for taxpayers in the affected areas.

#### **Explanation of Provision**

Under the provision, for taxpayers determined to be affected by the Presidentially declared disaster relating to Hurricanes Katrina, Rita, and Wilma, any administrative relief from required acts, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, shall be for a period ending not earlier than February 28, 2006.

#### **Effective Date**

The provision is effective on the date of enactment.

**F. Special Look-Back Rule for Determining Earned  
Income Credit and Refundable Child Credit  
(new sec. 1400S(d) of the Code)**

**Present Law**

**In general**

Present law provides eligible taxpayers with an earned income credit and a child credit. In general, the earned income credit is a refundable credit for low-income workers (sec. 32). The amount of the credit depends on the earned income of the taxpayer and whether the taxpayer has one, more than one, or no qualifying children. Earned income generally includes wages, salaries, tips, and other employee compensation, plus net earnings from self-employment.

Taxpayers with incomes below certain threshold amounts are eligible for a \$1,000 credit for each qualifying child (sec. 24). The child credit is refundable to the extent of 15 percent of the taxpayer's earned income in excess of \$10,000. (The \$10,000 income threshold is indexed for inflation and is currently \$11,000 for 2005.) Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit, if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of \$10,000 (indexed for inflation).

**Hurricane Katrina**

Certain qualified individuals affected by Hurricane Katrina may elect to calculate their earned income credit and refundable child credit for the taxable year which includes August 25, 2005, using their earned income from the prior taxable year (a "Katrina election"). Such qualified individuals are permitted to make the election only if their earned income for the taxable year which includes August 25, 2005, is less than their earned income for the preceding taxable year.

Individuals qualified to make a Katrina election are (1) individuals who on August 25, 2005, had their principal place of abode in the Hurricane Katrina "core disaster area" or (2) individuals who on such date were not in the core disaster area but lived in the Hurricane Katrina disaster area and were displaced from their homes. For purposes of this election, the term "core disaster area" means that portion of the Hurricane Katrina disaster area determined by the President to warrant individual or individual and public assistance from the Federal Government under such Act. The term "Hurricane Katrina disaster area" means an area with respect to which a major disaster had been declared by the President before September 14, 2005, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina. The States for which such a disaster had been declared are Alabama, Florida, Louisiana, and Mississippi.

In the case of a joint return for a taxable year which includes August 25, 2005, a Katrina election may be made if either spouse is a qualified individual. In such cases, the earned income for the preceding taxable year which is attributable to the taxpayer filing the joint return is the sum of the earned income which is attributable to each spouse for such preceding taxable year.

Any Katrina election applies with respect to both the earned income credit and refundable child credit. For administrative purposes, the incorrect use on a return of earned income pursuant to a Katrina election is treated as a mathematical or clerical error. A Katrina election is disregarded for purposes of calculating gross income in the election year.

### **Explanation of Provision**

The provision codifies the Katrina election. It also expands the rule governing Katrina elections to permit certain qualified individuals affected by Hurricane Rita and Hurricane Wilma to make similar elections.

In the case of Hurricane Rita certain qualified individuals may elect to calculate their earned income credit and refundable child credit for the taxable year which includes September 23, 2005, using their earned income from the prior taxable year (a “Rita election”). Qualified individuals for purposes of a Rita election are (1) individuals who on September 23, 2005, had their principal place of abode in the Rita GO Zone or (2) individuals who on such date had their principal place of abode in the Hurricane Rita disaster area but outside the Rita GO Zone and were displaced from that residence.

In the case of Hurricane Wilma certain qualified individuals may elect to calculate their earned income credit and refundable child credit for the taxable year which includes October 23, 2005, using their earned income from the prior taxable year (a “Wilma election”). Qualified individuals for purposes of a Wilma election are (1) individuals who on October 23, 2005, had their principal place of abode in the Wilma GO Zone or (2) individuals who on such date had their principal place of abode in the Hurricane Wilma disaster area but outside the Wilma GO Zone and were displaced from that residence.

Qualified individuals are permitted to make a Rita election or Wilma election only if their earned income for the taxable year which includes September 23, 2005 or October 23, 2005, respectively, is less than their earned income for the preceding taxable year.

In other respects, a Rita election or Wilma election is the same as a Katrina election under present law, except that the reference dates are September 23, 2005 for Rita and October 23, 2005 for Wilma and not August 25, 2005.

### **Effective Date**

The codification of the provision in the Katrina Emergency Tax Relief Act of 2005 takes effect on date of enactment. The expansion of the provision applies to taxable years that include September 23, 2005 in the case of Hurricane Rita and October 23, 2005 in the case of Hurricane Wilma.

**G. Secretarial Authority to Make Adjustments Regarding  
Taxpayer and Dependency Status  
(new sec. 1400S(e) of the Code)**

**Present Law**

**In general**

In order to determine taxable income, an individual reduces adjusted gross income (“AGI”) by any personal exemptions and either the standard deduction or itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents (as defined in sec. 151). Personal exemptions are not allowed for purposes of determining a taxpayer’s alternative minimum taxable income.

For 2005, the amount deductible for each personal exemption is \$3,200. This amount is indexed annually for inflation. The deduction for personal exemptions is phased out ratably for taxpayers with AGI over certain thresholds. These thresholds are indexed annually for inflation. Specifically, the total amount of exemptions that may be claimed by a taxpayer is reduced by two percent for each \$2,500 (or portion thereof) by which the taxpayer's AGI exceeds the applicable threshold. (The phaseout rate is two percent for each \$1,250 for married taxpayers filing separate returns.) Thus, the personal exemptions claimed are phased out over a \$122,500 range (which is not indexed for inflation), beginning at the applicable threshold. The applicable thresholds for 2005 are \$145,900 for single individuals, \$218,950 for married individuals filing a joint return, \$182,450 for heads of households, and \$109,475 for married individuals filing separate returns. For 2005, the point at which a taxpayer's personal exemptions are completely phased out is \$268,450 for single individuals, \$341,450 for married individuals filing a joint return, \$304,950 for heads of households, and \$170,725 for married individuals filing separate returns.

Present law provides eligible taxpayers with an earned income credit and a child credit. In general, the earned income credit is a refundable credit for low-income workers. The amount of the credit depends on the earned income of the taxpayer and whether the taxpayer has one, more than one, or no qualifying children. Earned income generally includes wages, salaries, tips, and other employee compensation, plus net earnings from self-employment.

Taxpayers with incomes below certain threshold amounts are eligible for a \$1,000 credit for each qualifying child. The child credit is refundable to the extent of 15 percent of the taxpayer's earned income in excess of \$10,000. (The \$10,000 income threshold is indexed for inflation and is currently \$11,000 for 2005.) Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit, if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of \$10,000 (indexed for inflation).

**Hurricane Katrina**

With respect to taxable years beginning in 2005 and 2006, the Secretary has authority to make such adjustments in the application of the Federal tax laws as may be necessary to ensure that taxpayers do not lose any deduction or credit or experience a change of filing status by

reason of temporary relocations caused by Hurricane Katrina. Such adjustments may include, for example, addressing the application of the residency requirements relating to dependency exemptions in the case of relocations due to Hurricane Katrina. Any adjustments made using this authority must insure that an individual is not taken into account by more than one taxpayer with respect to the same tax benefit.

#### **Explanation of Provision**

The provision codifies the Secretarial authority with respect to Hurricane Katrina. The provision also expands the Secretary's authority to make adjustments in the application of the Federal tax laws with respect to Hurricane Katrina to include taxpayers affected by Hurricane Rita and Hurricane Wilma.

#### **Effective Date**

The provision is effective with respect to taxable years beginning in 2005 or 2006.

## **H. Special Rules for Mortgage Revenue Bonds (new sec. 1400T of the Code)**

### **Present Law**

#### **In general**

Under present law, gross income does not include interest on State or local bonds (sec. 103). State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes (“qualified private activity bonds”) (secs. 103(b)(1) and 141).

#### **Qualified mortgage bonds**

The definition of a qualified private activity bond includes a qualified mortgage bond (sec. 143). Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for eligible mortgagors, purchase price limitations on the home financed with bond proceeds, and a “first-time homebuyer” requirement. The income limitations are satisfied if all financing provided by an issue is provided for mortgagors whose family income does not exceed 115 percent of the median family income for the metropolitan area or State, whichever is greater, in which the financed residences are located. The purchase price limitations provide that a residence financed with qualified mortgage bonds may not have a purchase price in excess of 90 percent of the average area purchase price for that residence. The first-time homebuyer requirement provides qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the “first-time homebuyer” requirement).

Special income and purchase price limitations apply to targeted area residences. A targeted area residence is one located in either (1) a census tract in which at least 70 percent of the families have an income which is 80 percent or less of the state-wide median income or (2) an area of chronic economic distress. For targeted area residences, the income limitation is satisfied when no more than one-third of the mortgages are made without regard to any income limits and the remainder of the mortgages are made to mortgagors whose family income is 140 percent or less of the applicable median family income. The purchase price limitation is raised from 90 percent to 110 percent of the average area purchase price for targeted area residences. In addition, the first-time homebuyer requirement does not apply to targeted area residences.

Qualified mortgage bonds also may be used to finance qualified home-improvement loans. Qualified home-improvement loans are defined as loans to finance alterations, repairs, and improvements on an existing residence, but only if such alterations, repairs, and

improvements substantially protect or improve the basic livability or energy efficiency of the property. Qualified home-improvement loans may not exceed \$15,000.

A temporary provision waived the first-time homebuyer requirement for residences located in certain Presidentially declared disaster areas (sec. 143(k)(11)). In addition, residences located in such areas were treated as targeted area residences for purposes of the income and purchase price limitations. The special rule for residences located in Presidentially declared disaster areas does not apply to bonds issued after January 1, 1999.

The Katrina Emergency Tax Relief Act (“KETRA”) waives the first-time homebuyer requirement with respect to certain residences located in an area with respect to which a major disaster has been declared by the President before September 14, 2005, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina (see sec. 404 of Pub. L. 109-73). KETRA also increases to \$150,000 the permitted amount of a qualified home-improvement loans with respect to residences located in the Hurricane Katrina disaster area to the extent such loan is for the repair of damage caused by Hurricane Katrina.

### **Explanation of Provision**

Under the provision, residences located in the GO Zone, the Rita GO Zone, or the Wilma GO Zone are treated as targeted area residences for purposes of section 143, with the modifications described below. Thus, the first-time homebuyer rule is waived and purchase and income rules for targeted area residences apply to residences located in the specified areas that are financed with qualified mortgage bonds. For these purposes, 100 percent of the mortgages must be made to mortgagors whose family income is 140 percent or less of the applicable median family income. Thus, the present law rule allowing one-third of the mortgages to be made without regard to any income limits does not apply. In addition, the proposal increases from \$15,000 to \$150,000 the amount of a qualified home-improvement loan with respect to residences located in the specified disaster areas.

The provision applies to residences financed before January 1, 2011.

(For a description of the extension of KETRA mortgage revenue bond rules, see I.A.20, - Special Rules for Mortgage Revenue Bonds, above.)

### **Effective Date**

The provision is effective on the date of enactment with respect to financing provided before January 1, 2011.

## **TITLE III – OTHER PROVISIONS**

### **A. Gulf Cost Recovery Bonds**

#### **Present Law**

Under Title 31, the Secretary, with the approval of the President, may issue savings bonds and savings certificates of the United States Government (31 U.S.C. sec. 3105). Proceeds from the bonds and certificates are used for expenditures authorized by law. Savings bonds and certificates may be issued on an interest-bearing basis, on a discount basis, or on an interest-bearing and discount basis. The difference between the price paid and the amount received on redeeming a savings bond or certificate is interest under the Code.

#### **Explanation of Provision**

The provision expresses the sense of Congress that the Secretary designate one or more series of obligations issued under Title 31 as “Gulf Coast Recovery Bonds” in response to Hurricanes Katrina, Rita, and Wilma.

#### **Effective Date**

The provision is effective on the date of enactment.

**B. Election to Treat Combat Pay as Earned Income for  
Purposes of the Earned Income Credit  
(sec. 32 of the Code)**

**Present Law**

**Child credit**

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

**Earned income credit**

Any taxpayer may elect to treat combat pay that is otherwise excluded from gross income under section 112 as earned income for purposes of the earned income credit. This election is available with respect to any taxable year ending after the date of enactment and before January 1, 2006.

**Explanation of Provision**

The provision extends the present-law rule relating to the earned income credit for one year (through December 31, 2006).

**Effective Date**

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

**C. Modifications of Suspension of Interest and Penalties Where  
Internal Revenue Service Fails to Contact Taxpayer  
(sec. 6404(g) of the Code)**

**Present Law**

In general, interest and penalties accrue during periods for which taxes were unpaid without regard to whether the taxpayer was aware that there was tax due. The Code suspends the accrual of certain penalties and interest starting 18 months after the filing of the tax return if the IRS has not sent the taxpayer a notice specifically stating the taxpayer's liability and the basis for the liability within the specified period. If the return is filed before the due date, for this purpose it is considered to have been filed on the due date. Interest and penalties resume 21 days after the IRS sends the required notice to the taxpayer. The provision is applied separately with respect to each item or adjustment. The provision does not apply where a taxpayer has self-assessed the tax. The suspension only applies to taxpayers who file a timely tax return. The provision applies only to individuals and does not apply to the failure to pay penalty, in the case of fraud, or with respect to criminal penalties.

The suspension of interest does not apply to interest accruing after October 3, 2004 with respect to underpayments resulting from listed transactions or undisclosed reportable transactions.

On October 27, 2005, the IRS announced a settlement initiative for 21 identified transactions. (See Internal Revenue Service Announcement 2005-80.) Under the terms of the settlement initiative, participants will be required to pay 100 percent of the taxes owed, interest and, depending on the transaction, either a quarter or a half of the penalty the IRS will otherwise seek. The IRS will grant penalty relief for transactions disclosed to the IRS or where the taxpayer got a tax opinion from an independent tax advisor. Transaction costs paid by the taxpayer, including professional and promoter fees, will be allowed. The application deadline for the settlement initiative is January 23, 2006.

**Explanation of Provision**

Under the provision, the exception for listed transactions and undisclosed reportable transactions also applies to interest accruing on or before October 3, 2004. However, taxpayers remain eligible for the present-law suspension of interest if the year in which the underpayment occurred is barred by the statute of limitations (or a closing agreement) as of December 14, 2005. Taxpayers may also remain eligible with respect to an transactions if the Secretary determines that the taxpayers has acted reasonably and in good faith with respect to that transactions.

In addition, under a special rule, taxpayers may remain eligible for the present-law suspension of interest by participating in the IRS settlement initiative described above with respect to that transaction. In order to be eligible under the special rule, the taxpayer must be participating in the settlement initiative (or have entered into a settlement agreement pursuant to the initiative) as of January 23, 2006. Furthermore, a taxpayer's eligibility under the special rule is revoked if the taxpayer ceases to participate in the settlement initiative or the Treasury determines that a settlement agreement will not be reached within a reasonable period of time.

The special rule applies on a transaction-by-transaction basis. Thus, participation in the settlement initiative with respect to an individual transaction qualifies the taxpayer for the present-law suspension of interest only with respect to interest and penalties on underpayments resulting from that transaction. If the taxpayer has entered into other listed or nondisclosed reportable transactions and is not participating in the settlement initiative with respect to those transactions, the special rule does not apply to interest and penalties resulting from those transactions.

The provision also provides that, if a taxpayer files an amended return or other signed written document showing that the taxpayer owes an additional amount of tax for the taxable year, the relevant 18-month period is measured from the latest date on which such documents were provided.

### **Effective Date**

The provision is effective as if included in the provisions of the American Jobs Creation Act of 2004 to which it relates, except that the rule relating to the restart of the 18-month period is effective for documents provided on or after the date of enactment.

**D. Authority for Undercover Operations  
(sec. 7608 of the Code)**

**Present Law**

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

The provision was originally enacted in The Anti-Drug Abuse Act of 1988. The exemption originally expired on December 31, 1989, and was extended by the Comprehensive Crime Control Act of 1990 to December 31, 1991. There followed a gap of approximately four and a half years during which the provision had lapsed. In the Taxpayer Bill of Rights II, the authority to use proceeds from undercover operations was extended for five years, through 2000. The Community Renewal Tax Relief Act of 2000 extended the authority of the IRS to use proceeds from undercover operations for an additional five years, through 2005.

**Explanation of Provision**

The provision extends for one year the present-law authority of the IRS to use proceeds from undercover operations to pay additional expenses incurred in conducting undercover operations (through December 31, 2006).

**Effective Date**

The provision is effective on the date of enactment.

## **E. Disclosures of Certain Tax Return Information**

### **1. Disclosure of tax information to facilitate combined employment tax reporting (sec. 6103(d)(5) of the Code)**

#### **Present Law**

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

The authority for this program expires December 31, 2005.

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

#### **Explanation of Provision**

The provision extends for one year the present-law authority for the combined employment tax reporting program (through December 31, 2006).

#### **Effective Date**

The provision applies to disclosures after December 31, 2005.

### **2. Disclosure of return information regarding terrorist activities (sec. 6103(i)(3) and (i)(7) of the Code)**

#### **Present Law**

##### **In general**

Section 6103 provides that returns and return information may not be disclosed by the IRS, other Federal employees, State employees, and certain others having access to the information except as provided in the Internal Revenue Code. Section 6103 contains a number of exceptions to this general rule of nondisclosure that authorize disclosure in specifically

identified circumstances (including nontax criminal investigations) when certain conditions are satisfied.

Among the disclosures permitted under the Code is disclosure of returns and return information for purposes of investigating terrorist incidents, threats, or activities, and for analyzing intelligence concerning terrorist incidents, threats, or activities. The term “terrorist incident, threat, or activity” is statutorily defined to mean an incident, threat, or activity involving an act of domestic terrorism or international terrorism, as both of those terms are defined in the USA PATRIOT Act (see sec. 6103(b)(11) and 18 U.S.C. secs. 2331(1) and 2331(5)). In general, returns and taxpayer return information must be obtained pursuant to an ex parte court order. Return information, other than taxpayer return information, generally is available upon a written request meeting specific requirements. The IRS also is permitted to make limited disclosures of such information on its own initiative to the appropriate Federal law enforcement agency.

No disclosures may be made under these provisions after December 31, 2005.

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

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

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

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

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

If the Secretary of Treasury possesses returns or return information that may be related to a terrorist incident, threat, or activity, the Secretary of the Treasury (or his delegate), may on his own initiative, authorize an application for an ex parte court order to permit disclosure to Federal law enforcement. In order to grant the order, the Federal district court judge or magistrate must determine that there is reasonable cause to believe, based upon information believed to be

reliable, that the return or return information may be relevant to a matter relating to such terrorist incident, threat, or activity. The information may be disclosed only to the extent necessary to apprise the appropriate Federal law enforcement agency responsible for investigating or responding to a terrorist incident, threat, or activity and for officers and employees of that agency to investigate or respond to such terrorist incident, threat, or activity. Further, use of the information is limited to use in a Federal investigation, analysis, or proceeding concerning a terrorist incident, threat, or activity. Because the Department of Justice represents the Secretary of the Treasury in Federal district court, the Secretary is permitted to disclose returns and return information to the Department of Justice as necessary and solely for the purpose of obtaining the special IRS ex parte court order.

### **Disclosure of return information other than by ex parte court order**

#### Disclosure by the IRS without a request

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

#### Disclosure upon written request of a Federal law enforcement agency

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

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

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

Upon written request satisfying certain requirements discussed below, the IRS is to disclose return information (other than taxpayer return information) to officers and employees of

the Department of Justice, Department of Treasury, and other Federal intelligence agencies, who are personally and directly engaged in the collection or analysis of intelligence and counterintelligence or investigation concerning terrorist incidents, threats, or activities. Use of the information is limited to use by such officers and employees in such investigation, collection, or analysis.

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

#### **Explanation of Provision**

The provision extends for one year the present-law terrorist activity disclosure provisions (through December 31, 2006).

#### **Effective Date**

The provision applies to disclosures after December 31, 2005.

### **3. Disclosure of return information to carry out income contingent repayment of student loans (sec. 6103(l)(13) of the Code)**

#### **Present Law**

Present law prohibits the disclosure of returns and return information, except to the extent specifically authorized by the Code. An exception is provided for disclosure to the Department of Education (but not to contractors thereof) of a taxpayer's filing status, adjusted gross income and identity information (i.e., name, mailing address, taxpayer identifying number) to establish an appropriate repayment amount for an applicable student loan. The disclosure authority for the income-contingent loan repayment program is scheduled to expire after December 31, 2005.

The Department of Education utilizes contractors for the income-contingent loan verification program. The specific disclosure exception for the program does not permit disclosure of return information to contractors. As a result, the Department of Education obtains return information from the Internal Revenue Service by taxpayer consent (under section 6103(c)), rather than under the specific exception for the income-contingent loan verification program (sec. 6103(l)(13)).

#### **Explanation of Provision**

The provision extends for one year the present law authority to disclose return information for purposes of the income-contingent loan repayment program (through December 31, 2006).

**Effective Date**

The provision applies to requests made after December 31, 2005.

## TITLE IV – TAX TECHNICAL CORRECTIONS

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

### A. Technical Corrections

#### Amendments Related to the Energy Policy Act of 2005

**Repeal of the Public Utility Holding Company Act of 1935 (Act sec. 1263).**—The provision repeals sections 1081-1083 of the Code (relating to exchanges in obedience to SEC orders) to conform to the repeal of the Public Utility Holding Company Act of 1935. The repeal does not apply to any exchange, expenditure, investment, distribution, or sale made in obedience to an order of the Securities and Exchange Commission.

**Extension and modification of renewable electricity production credit (Act sec. 1301).**—The provision makes a technical amendment to Code section 45(c)(3)(A)(ii) to change the wording of the reference to “nonhazardous lignin waste material” to “lignin material” so as not to infer that lignin is hazardous or waste.

**Clean renewable energy bonds (Act sec. 1303).**—Section 54(l)(5) treats the credits received by a holder of clean renewable energy bonds as payments of estimated tax for purposes of sections 6654 and 6655. Under the provision, section 54(l)(5) is repealed, as it may provide a double benefit when computing the estimated tax penalty in the manner prescribed under sections 6654(f) and 6655(g). The conforming amendments to the Act section are made for taxable years beginning after 2005.

**Credit for production from advanced nuclear power facilities (Act sec. 1306).**—The provision clarifies the production credit for advanced nuclear power (sec. 45J) to carry out the intent that the phase-out is indexed for inflation but the credit rate is not. Specifically, it is not intended that the inflation adjustment rule referred to in section 45J(e) be interpreted to apply to the credit rate in section 45J(a)(1) as well as the phase-out referred to in section 45J(c)(2). The provision clarifies that the phase-out is indexed but the credit rate is not.

**Expansion of amortization for certain atmospheric pollution control facilities in connection with plants first placed in service after 1975 (Act sec. 1309).**—The provision clarifies that the 84-month amortization period only applies to facilities used in connection with a plant or other property placed in service after December 31, 1975.

**Five-year net operating loss carryover for certain losses (Act sec. 1311).**—A number of clerical amendments are made to section 172(b)(1)(I).

**Modification of credit for producing fuel from a nonconventional source (Act sec. 1322).**—The provision clarifies that the credit is allowable without the requirement to make an election.

**Energy efficient commercial buildings deduction (Act sec. 1331).**—The provision repeals as deadwood certain language in section 1250.

**Credit for residential energy efficient property (Act sec. 1335).**—The provision clarifies that the dollar limitations are applied without regard to carryovers of the credit from prior taxable years.

Under the provision, the joint occupancy rule is redrafted to apply to expenditures with respect to a dwelling unit rather than the credit allowed with respect to the unit.

The rules relating to the carryover of unused personal credits (including the new credit for residential energy efficient property) are redrafted so as to include in the Code rules for both the taxable years in which the credits are allowed against the alternative minimum tax, and the taxable years in which the credits are not so allowed. The provision is effective for taxable years beginning after 2005.

**Alternative motor vehicle credit and credit for installation of alternative fueling stations (Act secs. 1341 and 1342).**—Sections 30B(h)(6) and 30C(e)(2) separate business and personal credits for purposes of applying limitations on the credits. Credit property is treated as subject to the business credit limitations if it is depreciable property. Each of these rules provides that the seller of property to a tax-exempt entity can claim the credit. The provision provides that the credits for property sold to a tax-exempt entity are subject to the business credit limitations.

**Expansion of research credit (Act sec. 1351).**—The research credit has an explicit rule preventing amounts from being taken into account more than once under the credit (i.e., preventing double benefits). The provision clarifies that the rule preventing amounts from being taken into account more than once also applies to the provisions of the research credit relating to energy research consortia.

The provision clarifies that qualified research with respect to energy research consortia must be conducted in the United States or Puerto Rico. This conforms the treatment of such qualified research to the treatment of other qualified research under the research credit in this respect.

#### **Amendments Related to the American Jobs Creation Act of 2004**

**Deduction relating to income attributable to domestic production activities (manufacturing deduction) (Act sec. 102).**—With respect to the W-2 wage limitation on the allowable amount of the domestic production activities deduction, the Act does not require Forms W-2 actually to be filed, and does not specify whether the employees must be the common law employees of the taxpayer. The provision clarifies that a taxpayer may take into account only wages that are paid to the common law employees of the taxpayer and that are reported on a Form W-2 filed with the Social Security Administration no later than 60 days after the extended due date for the Form W-2. Thus, the taxpayer may not take into account wages that were not actually reported. The provision also addresses situations in which the employer uses an agent to report its wages.

The provision clarifies that, in computing qualified production activities income, the domestic production activities deduction itself is not an allocable deduction. The provision also clarifies that no inference is intended with regard to the interpretive relationship between the cost allocation rules provided with respect to the domestic production activities deduction and the cost allocation rules provided with respect to provisions elsewhere in the Act (e.g., incentives to reinvest foreign earnings in the United States). The provision also corrects a reference to “income attributable to domestic production activities” to refer to the defined term “qualified production activities income.”

With regard to the definition of “domestic production gross receipts” as it relates to construction performed in the United States and engineering or architectural services performed in the United States for construction projects in the United States, the provision clarifies that the term refers only to gross receipts derived from the construction of real property by a taxpayer engaged in the active conduct of a construction trade or business, or from engineering or architectural services performed with respect to real property by a taxpayer engaged in the active conduct of an engineering or architectural services trade or business.

The provision clarifies that the term does not include gross receipts derived from the lease, rental, license, sale, exchange or other disposition of land.

The provision provides that gross receipts derived from certain contracts (or subcontracts) to manufacture or produce property for the Federal government are derived from the sale of such property and, therefore, are domestic production gross receipts. (Another section of the provision clarifies the authority of the Secretary to prescribe rules to prevent the domestic production activities deduction from being claimed by more than one taxpayer with respect to the same economic activity described in section 199(c)(4)(A)(i).)

The provision provides that, for purposes of determining the domestic production gross receipts of a partnership and its partners, provided all of the interests in the capital and profits of the partnership are owned by members of the same expanded affiliated group at all times during the taxable year of the partnership, then the partnership and all members of that expanded affiliated group are treated as a single taxpayer during such period. Thus, for example, assume such a partnership engages in an activity with respect to property manufactured by the partners that are members of the same expanded affiliated group, and the activity would be treated as a manufacturing activity, but for the fact that the partnership (rather than the partner) conducts the activity. Under this provision, then, the gross receipts derived from the activity are treated as domestic production gross receipts of the partnership for such taxable year. Once the partnership has determined its domestic production gross receipts in this manner, such receipts and the expenses, losses or deductions that are properly allocable to such receipts, and any other items that are allocated to partners, are allocated among the partners in accordance with the requirements of section 199(d)(1) (as amended). Similarly, if a partner engages in such an activity with respect to property manufactured by the partnership, then the gross receipts derived from the activity are treated as domestic production gross receipts of the partner. The treatment of the partners and the partnership as a single taxpayer under this rule is only for the purpose of determining domestic production gross receipts.

The provision clarifies that, with respect to the domestic production activities of a partnership or S corporation, the deduction under the Act is determined at the partner or shareholder level. In performing the calculation, each partner or shareholder generally will take into account such person's allocable share of the components of the calculation (including domestic production gross receipts; the cost of goods sold allocable to such receipts; and other expenses, losses, or deductions allocable to such receipts) from the partnership or S corporation as well as any items relating to the partner or shareholder's own qualified production activities, if any.

The provision clarifies the treatment provided under the Act of cooperatives and patrons with respect to the deduction under section 199. The provision clarifies that a patron who receives certain payments from an agricultural or horticultural cooperative that are attributable to qualified production activities income is allowed a deduction equal to the portion of the deduction allowed to the cooperative that is attributable to such income. The provision also clarifies that the patron's deduction is allowed in the year that the payment attributable to qualified production activities income is received. The cooperative's taxable income is not reduced under section 1382 by the portion of the payment that does not exceed the portion so deductible by the patron. For purposes of the deduction under section 199, the provision clarifies that agricultural or horticultural marketing cooperatives are treated as having manufactured, produced, grown, or extracted any qualifying production property marketed by the organization which its patrons have so manufactured, produced, grown, or extracted. For purposes of the deduction under section 199, an agricultural or horticultural cooperative is a cooperative engaged in the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural products, or in the marketing of agricultural or horticultural products.

The provision clarifies the definition of an expanded affiliated group, so that a corporation eligible for the deduction with respect to income of a subsidiary must own more than 50 percent, rather than 50 percent or more, of the subsidiary's stock by vote and value.

The provision rewrites the rule that the deduction under section 199 in computing alternative minimum taxable income ("AMTI") is the same as in computing the regular tax, except that, in the case of a corporation, the taxable income limitation is the corporation's AMTI.

The provision clarifies that unrelated business taxable income, rather than taxable income, applies for purposes of section 199(a)(1)(B) in computing the unrelated business income tax under section 511. (In computing AMTI of an organization which is a corporation subject to tax under section 511(a), AMTI applies for purposes of section 199(a)(1)(B). In computing AMTI of an organization other than a corporation, the section 199 deduction is the same as for the regular tax. See sec. 199(d)(6).)

The provision clarifies that the manufacturing deduction is not taken into account in computing any net operating loss or the amount of any net operating loss carryback or carryover. Thus, the deduction under section 199 cannot create, or increase, the amount of a net operating loss deduction.

The provision clarifies the authority of the Secretary to prescribe rules to prevent the domestic production activities deduction from being claimed by more than one taxpayer with respect to the same economic activity described in section 199(c)(4)(A)(i).

The provision clarifies that the manufacturing deduction is not taken into account in determining the amount of the alternative tax net operating loss deduction. For example, assume that for the calendar year 2005, a corporation has AMTI (before the NOL deduction and before the manufacturing deduction) and qualified production activities income of \$1 million, and has an alternative tax net operating loss (“ATNOL”) carryover to 2005 of \$5 million. Assume that the taxpayer has sufficient W-2 wages so as not to be limited under that rule. The ATNOL deduction for 2005 is \$900,000 (90 percent of \$1 million), reducing AMTI to \$100,000. The taxpayer must then further reduce the AMTI by a manufacturing deduction of \$3,000 (three percent of the lesser of \$1 million or \$100,000) to \$97,000. The ATNOL carryover to 2006 is \$4,100,000.

The provision coordinates the computation of adjusted taxable income of a corporation for purposes of computing a corporation’s limitation on the deduction for interest on certain indebtedness with the deduction under section 199. The provision also coordinates the computation of taxable income for purposes of computing a corporation’s charitable contribution deduction and a taxpayer’s deduction for percentage depletion with respect to oil and gas wells with the deduction under section 199.

The provision clarifies that, in applying the effective date of the deduction under section 199, items arising from a taxable year of a partnership, S corporation, estate, or trust beginning before 2005 are not taken into account for purposes of the rules providing that the deduction is determined at the shareholder, partner or similar level and the application of the wage limitation with respect to such entities.

**Family members treated as one shareholder of an S corporation election (Act sec. 231).**—The provision repeals the requirement that a family must elect to be treated as one shareholder for purposes of determining the number of shareholders for purposes of subchapter S. The provision also provides that the determination of whether a common ancestor is more than six generations removed from the youngest generation of shareholders is made at the latest of (i) the date the subchapter S election is made; (ii) the date a family member first holds stock in the S corporation; or (iii) October 22, 2004.

The provision treats the estate of a family member as a member of the family for purposes of determining the number of shareholders.

The provision also conforms the provision relating to certain adopted individuals and foster children with the amendments made by title II of the Working Families Tax Relief Act of 2004.

**Transfer of suspended losses incident to divorce (Act sec. 235).**—The effective date of section 235 of the Act is corrected to provide that it is effective for transfers after December 31, 2004.

**REIT provisions (Act sec. 243).**—The provision clarifies that a REIT may cure de minimis failures of asset requirements (other than the requirement that the REIT may not hold more than 10 percent (five percent for certain prior years) of the value of securities of a single issuer, for which failure-specific procedures are provided) by using the same procedures as the REIT may use for larger failures of asset tests.

The provision clarifies that the new rules that permit the curing of certain REIT failures apply to failures with respect to which the requirements of the new rules are satisfied in taxable years of the REIT beginning after the date of enactment. Similarly, the provision clarifies that the new rules governing deficiency dividends that allow the taxpayer to make a determination by filing a statement with the IRS apply to statements filed in taxable years of the REIT beginning after the date of enactment.

It is intended that the provisions of the Act that allow a REIT to correct failures of REIT qualification without losing its REIT status apply to corrections of failures for which the requirements for correction are satisfied after the date of enactment, regardless of whether such failures occurred in taxable years beginning on, before, or after the date of enactment. Similarly, it is intended that the provisions of the Act that allow deficiency dividends under section 860 to correct distribution failures, provided the deficiency is identified in a statement filed after the date of enactment in accordance with the provisions of the Act, apply to failures occurring in taxable years beginning on, before, or after the date of enactment.

The provision clarifies that the new hedging rules apply to transactions entered into in taxable years beginning after the date of enactment.

The provision clarifies that securities of a partnership held by a REIT prior to the date of enactment of the Act, that would have qualified as straight debt securities if the Act had never been enacted by virtue of the prior law requirement that the REIT hold at least 20 percent of the partnership equity, will continue to qualify (regardless of whether they were disposed of before the date of enactment or whether the REIT has disposed of its interest in the partnership equity to the 1-percent-or-less interest required by the Act) while held by the REIT (or its successor) until the earlier of the disposition or the original maturity date of such securities.

**Expensing of certain films and television production costs (Act sec. 244).**—The provision clarifies that the \$15 million production cost limitation and the 75 percent qualified compensation requirement are determined on an episode-by-episode basis (not an aggregate basis).

The provision adds rules for recapture as ordinary income of the deduction for expensing of certain films and television production costs in a manner similar to the recapture rules applicable to expensing under Code section 179.

**Railroad track maintenance credit (Act sec. 245).**—For purposes of the rule that prevents the claiming of the credit by more than one eligible taxpayer with respect to the same mile of track, the provision clarifies that Class II and Class III railroads that operate track under a lease are not required to obtain assignment from the track owner in order to utilize or assign the credit. Under the provision, the credit is limited in respect of the total number of miles of track

(1) owned or leased by the Class II or Class III railroad and (2) assigned by the Class II or Class III railroad for purposes of the credit.

The provision clarifies that a Class I railroad is not treated as a Class II or III railroad for purposes of the credit (and it is not eligible to claim the credit with respect to track it owns) by reason of performing track maintenance services (on the same or different track) for a Class II or III railroad.

The provision also clarifies the rules governing the assignment of track by Class II or III railroads. A track mile may be assigned only once per tax year, effective at the close of the tax year, and any track mile assigned may not also be taken into account by the assignor taxpayer for the tax year. An assigned track mile is taken into account by the assignee in the tax year which includes the effective date of the assignment.

**Election to determine corporate tax on certain international shipping activities using per ton rate (Act sec. 248).**—The provision strikes as deadwood the rule added by the Act regarding the operation of a qualifying vessel by a non-electing corporation that is a member of an electing group.

The provision clarifies section 1354(b) to provide that an election to determine income tax on certain international shipping activities using a per ton rate is timely if made on or before the due date (including extensions) for filing the tax return for the relevant taxable year.

The provision clarifies the treatment of operating agreements under the tonnage tax rules. An operating agreement is not a charter, but is instead an agreement with an owner or charterer of a qualifying vessel to provide operating or management services in respect of a qualifying vessel, for example, crew, technical, or commercial services. The provision makes clear that a person providing services for a vessel under an operating agreement is treated as operating the vessel and may elect tonnage tax treatment, assuming the other requirements for such treatment are met. However, a subcontractor to a person providing services under an operating agreement is neither treated as providing services under an operating agreement nor as operating a vessel for purposes of the tonnage tax. The provision of equipment, tools, provisions, or supplies would not be considered an operating agreement or part of an operating agreement unless such equipment, tools, provisions, or supplies are provided by the person providing the services under the operating agreement, and such equipment, tools, provisions, or supplies are provided in connection with such services.

Present law provides that in order to elect tonnage tax treatment, a person must meet a shipping activity requirement as well as “operate” a qualifying vessel. In general, the shipping activity requirement is met for a taxable year if, on average during such year, at least 25 percent of the aggregate tonnage of qualifying vessels “used” by the corporation (or controlled group) are owned by such corporation (or controlled group) or are chartered to such corporation (or controlled group) on bareboat charter terms. It is intended that a person providing services under an operating agreement is deemed to be “using” tonnage of qualifying vessels, and the appropriate amount of such tonnage is taken into account for purposes of this test. For example, if a corporation (not a member of a controlled group) meets the shipping activity requirement by owning or bareboat chartering sufficient tonnage of other qualifying vessels, it will qualify for

the tonnage tax provisions in respect of any qualifying vessel that it is treated as operating by reason of providing services under an operating agreement.

The provision clarifies that interests in operating agreements are taken into account for purposes of allocating the notional shipping income from the operation of qualifying vessels among respective ownership, charter, and operating agreement interests. In addition, in the case of a partnership operating a vessel, the extent of a partner's ownership, charter, or operating agreement interest is determined on the basis of the partner's interest in the partnership.

The provision makes a clerical amendment by eliminating subparagraph (B) of section 1355(c)(3) of the Code, because the rule of subparagraph (B) is encompassed in subparagraph (A).

**Computation of foreign tax credit in determining alternative minimum tax by farmers and fisherman using income averaging (Act sec. 314).**—The provision clarifies that in computing the regular tax for purposes of determining the alternative minimum tax of a farmer or fisherman using income averaging, the foreign tax credit does not need to be recomputed.

**Reforestation expensing recapture (Act sec. 322).**—The provision clarifies that the amortization provision applies to trusts and estates, but the deduction applies to estates (and not to trusts).

The provision provides that Code section 1245 is expanded to provide recapture rules for the new expensing provisions of Code section 194(b) (reforestation).

**Depreciation allowance for aircraft (Act sec. 336).**—Present-law rules for additional first-year depreciation provide criteria under which certain noncommercial aircraft, and certain property having longer production periods (as described in Code section 168(k)(2)(B)), can qualify for the extended placed-in-service date. The provision clarifies that either noncommercial aircraft or property having a longer production period can qualify.

**Recharacterization of overall domestic loss (Act sec. 402).**—The provision clarifies that, in a case in which an overall domestic loss is used as a carryback, the requirement in Code section 904(g)(2) that the taxpayer have elected the benefits of the foreign tax credit applies to the taxable year in which the loss is used.

**Look-through rules to apply to dividends from noncontrolled section 902 corporations (Act sec. 403).**—The provision adds a transition rule under which a taxpayer may elect not to apply the Act's look-through rules to taxable years beginning before January 1, 2005.

**Look-through treatment for sales of partnership interests (Act sec. 412).**—The provision clarifies that constructive ownership is taken into account in determining whether a controlled foreign corporation is a 25-percent owner of a partnership for purposes of the rule treating a sale of a partnership interest as a sale of a proportionate share of the assets of the partnership. This provision conforms the statutory language to the legislative history of the Act.

**Repeal of foreign personal holding company rules and foreign investment company rules (Act sec. 413).**—The provision repeals as deadwood Code section 532(b)(2), which

coordinated the foreign personal holding company and accumulated earnings tax regimes, and instead provides that in computing a corporation's accumulated taxable income, a deduction is allowed in the amount of any income of the corporation that resulted in an inclusion for a U.S. shareholder under Code section 951(a). In the case of a corporation that is otherwise subject to the accumulated earnings tax on a gross basis (under Treas. Reg. sec. 1.535-1(b)), appropriate adjustments are made to this deductible amount to take into account deductions that may have reduced the inclusion under Code section 951(a), but which would not otherwise have been allowable in computing accumulated taxable income. For example, in the case of a corporation that is generally subject to the accumulated earnings tax on a gross basis, if Code section 954(b)(5) has had the effect of reducing the amount of a subpart F inclusion, it would be appropriate to reduce accumulated taxable income by the amount that would have been included under Code section 951(a) without applying Code section 954(b)(5).

The provision also repeals as deadwood Code section 6683, which addresses the failure of a foreign corporation to file a required personal holding company return, a rule that is no longer needed in light of the provision of the Act exempting foreign corporations from the personal holding company rules.

**Modifications to treatment of aircraft leasing and shipping (Act. sec. 415).**—The provision clarifies that, for purposes of the foreign tax credit limitation as in effect for taxable years beginning before January 1, 2007, shipping income was defined to include income that meets the definition of foreign base company shipping income as in effect before the definition was repealed under section 415 of the Act. The repeal is effective for taxable years of foreign corporations beginning after December 31, 2004, and taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

**Application of FIRPTA to distributions from REITS (Act sec. 418).**—The provision clarifies that the new rules providing an exception from FIRPTA do not apply to regulated investment companies (“RICs”), but only to real estate investment trusts (“REITs”).

The provision clarifies that the period of time during which a foreign shareholder may not have held more than five percent of the class of stock with respect to which the distribution is made is the one-year period ending on the date of the distribution.

The provision clarifies that the new rules apply to any distribution of a REIT that is treated as a deduction for a taxable year of the REIT beginning after the date of enactment.

The provision clarifies that the new rules also apply to deficiency dividends under section 860 that are paid after the date of enactment but that are treated as deductible in taxable years beginning on or prior to the date of enactment. Such dividends qualify for the exclusion from FIRPTA treatment under the Act if the other requirements of the Act are met.

**Incentives to reinvest foreign earnings in the United States (Act sec. 422).**—The provision amends Code section 965(a)(2)(B) to clarify that distributions made indirectly through tiers of controlled foreign corporations are eligible for the benefits of Code section 965 only if they originate with a dividend received by one controlled foreign corporation from another controlled foreign corporation in the same chain of ownership described in Code section 958(a).

Thus, the first dividend in the sequence cannot be a portfolio dividend received by a controlled foreign corporation, for example.

The provision clarifies that for purposes of determining the amount of excess dividends eligible for the deduction, only cash dividends received during the elected taxable year are taken into account under Code section 965(b)(2)(A). (The base-period amounts described in Code section 965(b)(2)(B) include non-cash dividends, as well as cash dividends and certain other amounts.)

The provision also provides the Treasury Secretary with explicit regulatory authority to prevent the avoidance of the purposes of Code section 965(b)(3), which reduces the amount of eligible dividends in certain cases in which an increase in related-party indebtedness has occurred after October 3, 2004. Regulations issued pursuant to this authority may include rules to provide that cash dividends are not taken into account under Code section 965(a) to the extent attributable to the direct or indirect transfer of cash or other property from a related person to a controlled foreign corporation (including through the use of intervening entities or capital contributions). It is expected that this authority, which supplements existing principles relating to the treatment of circular flows of cash, would be used to prevent the application of the deduction in the case of a dividend that is effectively funded by the U.S. shareholder or its affiliates that are not controlled foreign corporations. It is anticipated that dividends would be treated as attributable to a related-party transfer of cash or other property under this authority only in cases in which the transfer is part of an arrangement undertaken with a principal purpose of avoiding the purposes of the related-party debt rule of Code section 965(b)(3).

For example, if a U.S. shareholder, as part of a plan to avoid the purposes of Code section 965(b)(3), contributes cash or other property to a controlled foreign corporation and then has the controlled foreign corporation pay a dividend to the U.S. shareholder (either to meet the base period repatriation level or as a dividend described in Code section 965(a)), or has the controlled foreign corporation lend the cash or other property to another controlled foreign corporation which then pays a dividend to the U.S. shareholder, regulations issued under this authority may require the U.S. shareholder to reduce its Code section 965(a) qualifying dividends by the amount of cash or other property contributed. In addition, if as part of a plan to avoid the purposes of Code section 965(b)(3), a U.S. shareholder makes a loan to a controlled foreign corporation after October 3, 2004, such controlled foreign corporation pays a dividend to the U.S. shareholder, and then the U.S. shareholder disposes of the stock of the controlled foreign corporation, such that the U.S. shareholder is not related to the controlled foreign corporation on the last day of the U.S. shareholder's election year, regulations issued under this authority may require the U.S. shareholder to reduce its Code section 965(a) qualifying dividends by the amount of the loan.

It is anticipated that many other transfers of cash or other property will not be regarded as effectively funding dividend repatriations for purposes of this regulatory authority. For example, if a U.S. shareholder, in the ordinary course of its trade or business, transfers cash or other property to a controlled foreign corporation in exchange for property or the provision of services, such a transfer will not be considered to have a principal purpose of avoiding the purposes of Code section 965(b)(3). Likewise, if a related person transfers cash to a controlled foreign corporation in a sale of assets by the controlled foreign corporation to the related person for non-

tax business purposes, such a transfer will not be considered to have a principal purpose of avoiding the purposes of Code section 965(b)(3). Similarly, a transfer of cash or other property to a controlled foreign corporation for purposes of providing initial or ongoing working capital to the controlled foreign corporation or expanding the controlled foreign corporation's operations will not be considered to have a principal purpose of avoiding the purposes of Code section 965(b)(3). In addition, a transfer by a U.S. shareholder in repayment of an obligation owed to a controlled foreign corporation will not be considered to have a principal purpose of avoiding the purposes of Code section 965(b)(3), absent special circumstances indicating that the U.S. shareholder is using the repayment effectively to fund the dividend repatriation. It is expected that these special circumstances would not be found to exist in cases involving the repayment of short-term debt (i.e., debt with a term of no more than three years).

In light of the timing of this bill and the fact that Code section 965 will expire for many affected taxpayers at the end of 2005, it is understood that the Treasury Department in all likelihood will not issue regulations under this authority. If no such regulations are issued, it would be expected that generally applicable tax principles would be invoked to reach results consistent with the principles and examples described above.

The provision also clarifies the definition of “applicable financial statement” under Code section 965(c)(1). In the case of a U.S. shareholder that is required to file a financial statement with the Securities and Exchange Commission (or is included in such a statement filed by another person), the provision clarifies that the applicable financial statement is the most recent audited annual statement that was so filed and certified on or before June 30, 2003. For purposes of this rule, a restatement of a previously filed and certified financial statement that occurs after June 30, 2003 does not alter the statement’s status as having been filed and certified on or before June 30, 2003. In addition, the provision clarifies that the term “applicable financial statement” includes the notes that form an integral part of the financial statement; other materials, including work papers or materials that may be filed for some purposes with a financial statement but that do not form an integral part of such statement, may not be relied upon for purposes of producing an earnings or tax number under the provision. For example, if a note that is an integral part of an applicable financial statement states that the U.S. shareholder has not provided for deferred taxes on \$1 billion of undistributed earnings of foreign subsidiaries because such earnings are intended to be reinvested permanently (or indefinitely) abroad, the U.S. shareholder’s limit under Code section 965(b)(1) is \$1 billion. If an applicable financial statement does not show a specific earnings or tax amount described in Code section 965(b)(1)(B) or (C), a taxpayer cannot rely on underlying work papers or other materials that are not a part of the financial statement to derive such an amount. If an applicable financial statement states that an earnings or tax amount is indeterminate (or that determination of a specific amount of earnings or taxes is not feasible), then the earnings or tax amount so described is treated as being zero. A specific earnings or tax amount can be relied upon for purposes of Code section 965(b)(1) as long as such amount is presented on the applicable financial statement as satisfying the indefinite reversal criterion of Accounting Principles Board Opinion 23 (“APB 23”) relating to deferred taxes on undistributed foreign earnings, and is disclosed as required under Financial Accounting Standards Board Statement 109 (“FAS 109”), regardless of whether the exact words “permanently reinvested” are used, and regardless of whether APB 23 or FAS 109 is cited by name.

The provision also clarifies that the expense disallowance rule of Code section 965(d)(2) applies only to deductions for expenses that are directly allocable to the deductible portion of the dividend. For these purposes, an expense is “directly allocable” if it relates directly to generating the dividend income in question. Thus, deductions for direct expenses such as certain legal and accounting fees and stewardship costs are disallowed under this provision. Deductions for indirect expenses such as interest, research and experimentation costs, sales and marketing costs, state and local taxes, general and administrative costs, and depreciation and amortization are not disallowed under this provision.

In addition, the provision clarifies that foreign taxes that are not allowed as foreign tax credits by reason of Code section 965(d) do not give rise to income inclusions under Code section 78.

The provision also clarifies that under Code section 965(e)(1), the only foreign tax credits that may be used to reduce the tax on the nondeductible portion of a dividend are credits for foreign taxes that are attributable to the nondeductible portion of the dividend. Credits for other foreign taxes cannot be used to reduce the tax on the nondeductible portion of the dividend.

The provision also clarifies Code section 965(f) to provide that an election to apply Code section 965 is timely if made on or before the due date (including extensions) for filing the tax return for the relevant taxable year.

**Treatment of deduction for State and local sales taxes under the alternative minimum tax (Act sec. 501).**—The provision clarifies that the itemized deduction for State and local sales taxes does not apply in calculating alternative minimum taxable income.

**Naval shipbuilding (Act sec. 708).**—The provision provides that the five-taxable year period for use of the 40/60 percentage-of-completion/capitalized cost method is determined with respect to the construction commencement date, not the contract commencement date. The provision further provides that any change of accounting method required by the provision is not subject to section 481.

**Credit for production of refined coal (Act sec. 710).**—The provision strikes the word “synthetic” from the definition of refined coal to carry out the intent that qualifying solid fuels produced from coal (including lignite) meet two new primary standards, an emissions reduction test and a value enhancement test, and not also be subject to a “chemical change” test promulgated under Treasury guidance for certain fuels from coal to qualify for credit under Code sec. 29.

**Tax treatment of expatriated entities and their foreign parents (Act sec. 801).**—The provision clarifies that the inversion gain rule of Code section 7874(a)(1) does not apply to an entity that is an expatriated entity with respect to an entity that is treated as a domestic corporation under Code section 7874(b).

**Expatriation of individuals (Act sec. 804).**—The provision clarifies that the exception to the requirement of minimal prior physical presence in the United States is both for (i) teachers, students, athletes, and foreign government individuals, and (ii) individuals receiving medical attention.

The provision clarifies that the Act does not create an additional requirement that an individual file a statement under section 6039G if such a filing was not already required under present law.

The provision clarifies that taxpayers who lose citizenship or terminate long-term resident status will continue to be treated for Federal tax purposes as citizens or long-term residents until they meet the notice and information reporting requirements of section 7701(n).

**Penalty for failure to disclose reportable transactions (Act sec. 811).**—The provision clarifies that the penalty for failing to disclose participation in a reportable transaction applies to returns and statements that are filed after the date of enactment, without regard to the original or extended due date for such return or statement.

**Accuracy-related penalties for listed transactions and reportable transactions with a significant tax avoidance purpose (Act sec. 812).**—The provision clarifies that underpayments attributable to an understatement resulting from participation in a listed transaction or a reportable transaction with a significant tax avoidance purpose are not subject to accuracy-related penalties under section 6662 to the extent that an accuracy-related penalty under section 6662A is imposed upon such underpayment. (However, in the case of underpayments resulting from substantial valuation misstatements, the accuracy-related penalty under section 6662A does not apply to the extent that the accuracy-related penalty under section 6662 is applied to such underpayments (i.e., the section 6662 penalty amount is increased under section 6662(h) because the substantial valuation misstatement is determined to be a gross valuation misstatement).) The provision clarifies that accuracy-related penalties under section 6662A do not apply to underpayments to which a fraud penalty under section 6663 is applied.

The provision clarifies that, with respect to disqualified opinions, the strengthened reasonable cause exception to section 6662A penalties does not apply to the opinion of a tax advisor if (1) the opinion was provided to the taxpayer before the date of enactment, (2) the opinion relates to a transaction entered into before the date of enactment, and (3) the tax treatment of items relating to the transaction was included on a return or statement filed by the taxpayer before the date enactment.

**Statute of limitations for unreported listed transactions (Act sec. 814).**—The Act provides that the statute of limitations with respect to an undisclosed listed transaction does not expire until one year after the earlier of (1) the date on which the Secretary is furnished the required information, or (2) the date on which a material advisor satisfies the list maintenance requirements with respect to a request by the Secretary. The provision clarifies that a “material advisor” for this purpose includes either a material advisor as defined in section 6111(b)(1) or, in the case of material aid, assistance, or advice rendered on or before the date of enactment, a material advisor as defined in Treasury regulations under section 6112. (See Treas. Reg. sec. 301.6112-1(c)(2).)

**Material advisor list maintenance requirement and penalty (Act sec. 815).**—The provision clarifies that the penalty under section 6708 for failing to comply with the section 6112 list maintenance requirements applies to both (1) material advisors with respect to reportable transactions under present-law section 6112, and (2) organizers and sellers of potentially abusive

tax shelters under prior-law section 6112. (This provision also would clarify the determination of the date on which a material advisor satisfies the list maintenance requirements for purposes of the extended statute of limitations for undisclosed listed transactions under section 814 of the Act.)

**Minimum holding period for withholding taxes on gain and income other than dividends (Act sec. 832).**—The provision clarifies that the exception from the minimum holding period for certain withholding taxes paid by registered or licensed brokers and dealers on income and gain from securities also apply to gain from the sale of stock.

**Disallowance of certain partnership loss transfers (Act sec. 833).**—The provision redrafts the wording of the provision relating to basis adjustments to undistributed partnership property in Code section 734(b) to clarify that it applies in the case of a distribution of property to a partner by a partnership with respect to which there is a substantial basis reduction.

**Repeal of special rules for FASITs and modifications to rules for REMICs (Act sec. 835).**—The provision clarifies that, if more than 50 percent of the obligations transferred to, or purchased by, a REMIC are originated by a government entity and are principally secured by an interest in real property, then each obligation originated by a government entity and transferred to, or purposed by, the REMIC is treated as principally secured by an interest in real property. Thus, the provision more closely aligns this rule with the “principally secured” standard that generally is provided by the definition of a qualified mortgage, and the provision clarifies that the treatment of obligations as principally secured by an interest in real property under this rule does not extend to obligations that are not originated by a government entity.

**Importation or transfer of built-in losses (Act sec. 836).**—The provision provides that on the tax-free liquidation of a corporation, the fair market value basis rule applies only to property described in section 362(e)(1)(B), i.e., property which became subject to U. S. income tax on the liquidation. The provision is drafted to conform the scope of the liquidation rule to the rule applicable to transfers of property by shareholders to corporations.

The provision provides that the election under section 362(e)(2)(C) to apply the basis limitation to the transferor's stock basis is made at such time and in such form and manner as the Secretary may prescribe, and, once made, is irrevocable.

**Sale of principal residence following section 1031 exchange (Act sec. 840).**—The provision clarifies that the exclusion under section 121 is denied on the sale or exchange of a principal residence by a taxpayer who did not recognize gain under section 1031 on the exchange in which the residence was acquired (or a by person whose basis in the residence is determined in whole or in part with reference to the basis of the residence in the hands of that taxpayer). The provision also makes a clerical change to the numbering of paragraphs.

**Limitation on deductions allocable to property used by tax-exempt entities (Act sec. 849).**—The Act establishes rules to limit deductions that are allocable to tax-exempt use property. For this purpose, the Act generally defines “tax-exempt use property” by reference to the definition provided in section 168(h). Section 168(h) generally provides that tax-exempt use property includes tangible property that is leased to a tax-exempt entity, as well as certain

property owned by a partnership that has a tax-exempt partner and provides for certain special allocations. The provision clarifies that the deduction limitation rules established by the Act apply without regard to whether the tax-exempt use property is treated as such by reason of a lease or otherwise (e.g., because the property is owned by a partnership that has a tax-exempt partner and provides for certain special allocations). In the case of property treated as tax-exempt use property other than by reason of a lease, the provision clarifies that the deduction limitation rules generally are effective for property acquired after March 12, 2004.

**Reporting with respect to donations of motor vehicles, boats and airplanes**

**(Act sec. 884).**—The provision clarifies that the acknowledgement by the donee organization is to include whether the donee organization provided any goods or services in consideration of the vehicle, and a description and good faith estimate of the value of any such goods or services, or, if the goods or services consist solely of intangible religious benefits, a statement to that effect.

**Nonqualified deferred compensation plans (Act sec. 885).**—The provision clarifies that the additional tax and interest under the nonqualified deferred compensation provision of the Act are not treated as payments of regular tax for alternative minimum tax purposes. The provision also clarifies that the application of the rule providing that certain additional deferrals must be for a period of not less than five years is not limited to the first payment for which deferral is made. The provision also clarifies that Treasury Department guidance providing a limited period during which plans can conform to the requirements applies to plans adopted before January 1, 2005. The provision also clarifies that the effective date of the funding provisions relating to offshore trusts and financial triggers is January 1, 2005. Thus, for example, amounts set aside in an offshore trust before such date for the purpose of paying deferred compensation and plans providing for the restriction of assets in connection with a change in the employer's financial health are subject to the funding provisions on January 1, 2005. Under the provision, not later than 90 days after the date of enactment of this provision, the Secretary of the Treasury shall issue guidance under which a nonqualified deferred compensation plan which is in violation of the requirements of the funding provisions relating to offshore trusts and financial triggers will be treated as not violating such requirements if the plan comes into conformance with such requirements during a limited period as specified by the Secretary in guidance. For example, trusts or assets set aside outside of the United States that would otherwise result in income inclusion and interest under the provision as of January 1, 2005, may be modified to come into conformance with the provision during the limited period of time as specified by the Secretary.

**Identified straddles (Act sec. 888).**—The provision clarifies that taxpayers are permitted to identify a straddle as an identified straddle under section 1092(a)(2)(B) (by making a clear and unambiguous identification on their books and records) without regard to whether the Secretary has prescribed regulations under the mandate in that section. The provision provides that the Secretary's mandate under the provision is to issue guidance in the form of regulations or in another form.

**Modification of treatment of transfers to creditors in divisive reorganizations**

**(Act sec. 898).**—The provision clarifies that the amount of the adjusted basis of property that is taken into account for purposes of Code section 361(b)(3) is reduced by the liabilities assumed (within the meaning of Code section 357(c)).

**Nonqualified preferred stock (Act sec. 899).**—The provision clarifies that the “real and meaningful likelihood” requirement under the Act (which applies so that stock shall not be treated as participating in corporate growth to any significant extent unless there is a “real and meaningful likelihood” of the shareholder actually participating in the earnings and growth of the corporation) applies also for purposes of determining whether stock is not stock that is “limited and preferred as to dividends.”

**Consistent amortization period for intangibles and treatment of partnership organizational expenses (Act sec. 902).**—The provision corrects the reference to “taxpayers” to refer to “partnerships” in the rules relating to deduction or amortization of partnership organizational expenses.

**Limitation of employer deduction for certain entertainment expenses (Act sec. 907).**—Section 907 of the Act limits the deduction for certain entertainment expenses with respect to specified individuals. A specified individual is defined as any individual subject to the requirements of section 16(a) of the Securities Act of 1934 with respect to the taxpayer or who would be subject to such requirements if the taxpayer were an issuer of equity securities. The provision clarifies that a specified individual includes an individual who is subject to the requirements of section 16(a) of the Securities Act of 1934 with respect to a related entity of the taxpayer or who would be subject to such requirements if the related entity were an issuer of equity securities.

#### **Amendment Related to the Working Families Tax Relief Act of 2004**

**Uniform definition of child (Act secs. 201, 203 and 207).**—The provision makes conforming amendments, consistent with those enacted with respect to various other provisions, for purposes of health savings accounts, the dependent care credit, and dependent care assistance programs. Under the conforming amendments, an individual may qualify as a dependent for these limited purposes without regard to whether the individual has gross income that exceeds an otherwise applicable gross income limitation or is married and files a joint return. In addition, such an individual who is treated as a dependent under these conforming amendment provisions is not subject to the general rule that a dependent of a taxpayer shall be treated as having no dependents for the taxable year of such individual beginning in such calendar year.

The provision clarifies Code section 152(e) to permit a divorced or legally separated custodial parent to waive, by written declaration, his or her right to claim a child as a dependent for purposes of the dependency exemption and child credit (but not with respect to other child-related tax benefits). By means of the waiver, the noncustodial parent is granted the right to claim the child as a dependent for these purposes. The provision clarifies that the waiver rules under the uniform definition of qualifying child operate as under prior law.

#### **Amendment Related to the Jobs and Growth Tax Relief Reconciliation Act of 2003**

**Bonus depreciation (Act sec. 201).**—Present-law rules for additional first-year depreciation provide criteria under which certain noncommercial aircraft, and certain property having longer production periods (as described in Code section 168(k)(2)(B)), can qualify for the extended placed-in-service date. The provision clarifies that property acquired and placed in

service during 2005 pursuant to a written binding contract which was entered into after May 5, 2003, and before January 1, 2005, is eligible for 50-percent additional first-year depreciation deduction.

The provision corrects the reference to a date in the rules applicable to qualified New York Liberty Zone property so that it refers to the January 1, 2005, date in the corresponding rule for additional first-year depreciation in Code section 168(k).

### **Amendments Related to the Victims of Terrorism Tax Relief Act of 2001**

**Rules relating to disclosure of taxpayer return information (Act sec. 201).**—The provision corrects cross references within the disclosure rules (Code section 6103) relating to disclosure to the National Archives and Records Administration.

### **Amendments Related to the Economic Growth and Tax Relief Reconciliation Act of 2001**

**Option to treat elective deferral as after-tax Roth contributions (Act sec. 617).**—A special rule allows employees with at least 15 years of service with certain organizations to make additional elective deferrals to a tax-deferred annuity, subject to an annual and cumulative limit. The cumulative limit is \$15,000, reduced by any additional pretax elective deferrals made for preceding years. For taxable years beginning after 2005, plans may allow employees to designate pretax elective deferrals as Roth contributions. Under the provision, the \$15,000 cumulative limit is reduced also by designated Roth contributions made for preceding years.

**Equitable treatment for contributions to defined contribution plans (Act sec. 632).**—Under the law as in effect before the Act, a special limit applied to contributions to tax-sheltered annuities for foreign missionaries with adjusted gross income not exceeding \$17,000. The special limit was inadvertently dropped by the Act. The special limit was restored in a technical correction in the Job Creation and Worker Assistance Act of 2002, but did not accurately reflect the pre-Act rule. The provision revises the special limit to reflect the pre-Act rule.

### **Amendments Related to the Internal Revenue Service Restructuring and Reform Act of 1998**

**Special procedures for third-party summons (Act sec. 3415).**—Code section 7609(c)(2)(F) provides that section 7609 does not apply to a summons described in subsection (f) or (g), which refers to a John Doe summons and certain emergency summonses, respectively. The provision corrects this reference, so as to make only the notice procedures of section 7609(a) inapplicable to a John Doe summons or an emergency summons, rather than making the entire section 7609 inapplicable.

### **Amendments Related to the Taxpayer Relief Act of 1997**

**Tentative carryback and refund adjustments and treatment of carrybacks or adjustments for certain unused deductions (Act sec. 1055).**—The provision corrects a reference in rules relating to tentative carryback and refund adjustments to refer to coordination rules in Code section 6611(f)(4)(B). The provision also corrects a reference in rules relating to

carrybacks or adjustments of certain unused deductions to refer to the filing date within the meaning of Code section 6611(f)(4)(B).

**Adjustments to basis of stock in controlled foreign corporations**

**(Act sec. 1112(b)).**—The provision clarifies that the basis adjustments of Code section 961(c) apply not only with respect to the stock of the controlled foreign corporation that earns the subpart F income that gives rise to the basis adjustments, but also with respect to the stock of higher-tier controlled foreign corporations in the same chain of ownership.

**Notice of certain transfers to foreign persons (Act sec. 1144).**—The provision corrects the omission of a conjunction in the description of transfers that are generally subject to certain information reporting requirements.

**Amendment Related to the Omnibus Budget Reconciliation Act of 1990**

**Depreciation of certain solar- or wind-powered equipment (Act sec. 11813).**—The provision clarifies that 5-year property includes certain heating, cooling, and other equipment using solar or wind (rather than solar and wind) energy.

**Amendment Related to the Omnibus Budget Reconciliation Act of 1987**

**Clarification of earnings and profits and stock basis where LIFO recapture tax applies (Act sec. 10227).**—Under present law, the LIFO recapture amount is included in the income of a C corporation that becomes an S corporation for its last taxable year that it was a C corporation (sec. 1363(d)). Any increase in tax by reason of this inclusion is payable in four equal annual installments. The provision provides that the rules relating to (1) the prohibition on adjustments of earnings and profits of an S corporation and (2) the requirement to reduce the basis of stock of the S corporation by reason of nondeductible expenses do not apply to any corporate tax imposed by reason of section 1363(d). No inference is intended as to the treatment of other corporate taxes.

**Clerical amendments**

The provisions include clerical and typographical amendments to the Code, which are effective upon enactment.

## B. Other Corrections

### Amendments Related to the American Jobs Creation Act of 2004

**Expansion of bank S corporation eligible shareholders to include IRAs (Act sec. 233).**—The provision expands the provision in the Act allowing certain bank stock to be held by an IRA (or to be sold by an IRA to the beneficiary) to include stock in a depository holding company (as defined in section 3(w)(1) of the Federal Deposit Insurance Act). A depository holding company includes a bank holding company and a thrift holding company.

**Exclusion of investment securities income from passive income test for bank S corporations (Act sec. 237).**—The provision expands the rule in the Act which provides that, in the case of a bank, bank holding company, or financial holding company, certain interest and dividend income is not treated as passive under the S corporation passive investment income rules. Under the provision, this rule applies to a bank and to a depository holding company (as defined in section 3(w)(1) of the Federal Deposit Insurance Act). A depository holding company includes a bank holding company and a thrift holding company.

**Information returns for qualified subchapter S subsidiaries (Act sec. 239).**—The provision provides that an S corporation and a qualified subchapter S subsidiary are recognized as a separate entities for purposes of making information returns, except as otherwise provided by the Treasury Department.