

**DESCRIPTION OF THE CHAIRMAN'S MARK  
OF THE  
"TAX RELIEF ACT OF 2005"**

Scheduled for Markup  
By the  
SENATE COMMITTEE ON FINANCE  
on November 10, 2005

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



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## INTRODUCTION

The Senate Committee on Finance has scheduled a markup on November 10, 2005, of the “Tax Relief Act of 2005,” which provides for reconciliation pursuant to section 202(b) of the concurrent resolution on the budget for fiscal year 2006. This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman’s Mark of the “Tax Relief Act of 2005.”

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman’s Mark of the “Tax Relief Act of 2005”* (JCX-71-05), November 8, 2005.

# **I. TAX BENEFITS FOR AREAS AFFECTED BY HURRICANES KATRINA, RITA, AND WILMA**

## **A. Gulf Recovery Zone Benefits**

### **1. Definitions**

#### **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.

#### **Gulf Opportunity Zone**

For purposes of the proposal, 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 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.

#### **Definition of Rita Zone**

The term “Rita 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 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 October 25, 2005, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act, by reason of Hurricane Wilma.

#### **Wilma Zone**

The term “Wilma 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.

## **2. Bonus depreciation for Gulf Opportunity Zone property**

### **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.<sup>2</sup> 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.

### **Description of Proposal**

The proposal 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.<sup>3</sup> 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 proposal 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

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<sup>2</sup> Sec. 179.

<sup>3</sup> 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 additional first-year depreciation deduction is not allowed for purposes of computing earnings and profits.

to which the proposal applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

Qualified Gulf Opportunity Zone Property means property which meets all of the following requirements. First, the property must be (1) property to which the general rules of the Modified Accelerated Cost Recovery System (“MACRS”)<sup>4</sup> apply and which has an applicable recovery period of 20 years or less, (2) computer software other than computer software covered by section 197,<sup>5</sup> (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<sup>6</sup> must commence with the taxpayer after August 27, 2005.<sup>7</sup> Finally, the property must be acquired by purchase<sup>8</sup> by the taxpayer after August 27, 2005 and placed in service on or before December 31, 2007 (in the case of 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

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<sup>4</sup> A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.

<sup>5</sup> Computer software is not covered by section 197 (and therefore is eligible for the additional first-year depreciation deduction) if (1) it is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified, or (2) it is separately acquired (i.e., not as part of the acquisition of a trade or business).

<sup>6</sup> Thus, used property may constitute qualified property so long as it has not previously been used within the Gulf Opportunity Zone. In addition, it is intended that additional capital expenditures incurred to recondition or rebuild property the original use of which in the Gulf Opportunity Zone began with the taxpayer would satisfy the “original use” requirement. See Treasury Regulation 1.48-2 Example 5.

<sup>7</sup> A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property will be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

If property is originally placed in service by a lessor (including by operation of section 168(k)(2)(D)(i)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

<sup>8</sup> For purposes of this proposal, purchase is defined under section 179(d).

qualify if a binding written contract for the acquisition of such property was in effect before August 28, 2005.<sup>9</sup>

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction, or production of the property after August 27, 2005, and the property is placed in service on or before December 31, 2007<sup>10</sup> (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

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. Similarly, property which is a qualified revitalization building within the meaning of section 1400I, and with respect to which a taxpayer has elected to claim accelerated cost recovery under that section,<sup>11</sup> is not eligible for the additional first-year depreciation deduction of the proposal.

Recapture rules apply under the proposal if the property ceases to be qualified Gulf Opportunity Zone property.

### **Effective Date**

The proposal is effective for taxable years ending after August 27, 2005, for qualified Gulf Opportunity Zone property placed in service after August 27, 2005, and before December 31, 2007 (before December 31, 2008 in the case of nonresidential real property and residential rental property).

## **3. Increase in expensing for Gulf Opportunity Zone property**

### **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

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<sup>9</sup> 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.

<sup>10</sup> 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.

<sup>11</sup> Section 1400I allows taxpayers to elect to claim either an immediate deduction of one-half of so-called “qualified revitalization expenditures” chargeable to capital account, or to ratably deduct such expenditures over a 120-month period, with regard to a “qualified revitalization building” located in a renewal community.

of qualifying property placed in service for the taxable year.<sup>12</sup> 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.<sup>13</sup>

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.<sup>14</sup>

### **Description of Proposal**

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 section 179 property (as defined in section 179(d)) that is qualified Gulf Opportunity Zone property for the taxable year. The proposal applies with respect to qualified 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 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 Gulf Opportunity Zone property that is section 179 property, resulting in a maximum deductible

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<sup>12</sup> 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).

<sup>13</sup> 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.

<sup>14</sup> 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. T.D. 9209, July 12, 2005. For taxable years beginning in 2008 and thereafter, an expensing election may be revoked only with consent of the Commissioner. Sec. 179(c)(2).

amount of \$200,000<sup>15</sup> of such qualified Gulf Opportunity Zone property. The \$100,000 additional amount for the cost of qualified Gulf Opportunity Zone property is not indexed.

The proposal provides a special rule for the reduction in the \$200,000 maximum deduction for the cost of qualified 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 Gulf Opportunity Zone property placed in service during the taxable year exceeds a dollar cap of up to \$1 million.<sup>16</sup> 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 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 proposal, 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 Gulf Opportunity Zone property). Under the proposal, 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 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 proposal, the \$400,000 phase-out amount in section 179(b)(2) is increased to \$600,000 by the \$200,000 cost of qualified 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 proposal, the taxpayer may deduct \$150,000 (\$200,000 less \$50,000) under section 179 for the taxable year.

Qualified 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 after

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<sup>15</sup> 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.

<sup>16</sup> 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.

August 27, 2005, (4) which is acquired by the taxpayer by purchase after August 27, 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 proposal includes rules coordinating with increased section 179 amounts provided with respect to enterprise zone businesses in empowerment zones and with respect to renewal communities. For purposes of those rules, qualified Gulf Opportunity Zone property is not treated as qualified zone property or qualified renewal property, unless the taxpayer elects not to have this proposal apply to all such qualified Gulf Opportunity Zone property the taxpayer places in service during the taxable year. 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 proposal for all such property placed in service during the taxable year, or under the empowerment zone or renewal community rules, but not both.

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

#### **Effective Date**

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

### **4. Tax-exempt bond financing for the Gulf Opportunity Zone**

#### **Present Law**

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

###### **In general**

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

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

Private activity bonds are eligible for tax-exemption if issued for certain purposes permitted by the Code (“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.<sup>17</sup> 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.<sup>18</sup>

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.<sup>19</sup>

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,

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<sup>17</sup> Sec. 141(e).

<sup>18</sup> Present law also 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”). Liberty Zone Bonds must be issued before January 1, 2010.

<sup>19</sup> The Katrina Emergency Tax Relief Act (“KETRA”), Pub. L. No. 109-73, 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.

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. Generally, qualified home-improvement loans may not exceed \$15,000.<sup>20</sup>

Issuance of most qualified private activity bonds is subject (in whole or in part) to annual State volume limitations (“volume cap”)<sup>21</sup> Exceptions to volume cap 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, issuance of qualified private activity bonds generally is subject to restrictions on 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). 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.

### **Description of Proposal**

The proposal authorizes the State of Alabama, Louisiana, or Mississippi, or any political subdivision thereof, to issue qualified private activity bonds that are not subject to present-law volume cap restriction (“Gulf Opportunity Zone Bonds”). Issuance of bonds authorized under the proposal is limited to projects approved by the Governor of the State 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.<sup>22</sup> Gulf Opportunity Zone Bonds must be issued after the date of enactment and before January 1, 2011.

Gulf Opportunity Zone Bonds may be issued to finance projects permitted under present law (e.g., qualified residential rental projects, certain owner-occupied housing). Thus, Gulf Opportunity Zone Bonds must satisfy present-law requirements for qualified private activity bonds, except as modified by this proposal.

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<sup>20</sup> KETRA 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.

<sup>21</sup> Sec. 146.

<sup>22</sup> 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. The bonds may not be advance refunded.

Under the proposal, residences located in the Gulf Opportunity Zone are treated as targeted area residences for purposes of section 143. Thus, the first-time homebuyer rule is waived and purchase and income rules for targeted area residences apply to residences financed with Gulf Opportunity Zone 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.<sup>23</sup> In addition, the proposal increases from \$15,000 to \$150,000 the amount of a qualified home-improvement loan that may be financed with bond proceeds.

Interest on Gulf Opportunity Zone Bonds is not a preference item for purposes of the alternative minimum tax.

### **Effective Date**

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

## **5. Additional advance refunding of certain tax-exempt bonds**

### **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 bond. Tax-exempt private activity bonds also include exempt facility bonds. The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (e.g., airports, docks, and wharves).

#### **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.<sup>24</sup> Proceeds of advance refunding bonds are generally invested in an escrow

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<sup>23</sup> Thus, the present law rule allowing one-third of the mortgages to be made without regard to any income limits does not apply.

<sup>24</sup> Sec. 149(d)(5).

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.<sup>25</sup> Private activity bonds, other than qualified 501(c)(3) bonds, may not be advance refunded.<sup>26</sup>

### **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.

### **Description of Proposal**

The proposal permits an additional advance refunding of certain governmental bonds issued by the State of Alabama, Louisiana, or Mississippi, or any political subdivision thereof. Bonds that may be advance refunded under this provision include only bonds 90 percent of the proceeds of which (95 percent in the case of a qualified 501(c)(3) bond) were used to finance facilities located in the Gulf Opportunity Zone (or property which is functionally related and subordinate to facilities located in the Gulf Opportunity Zone). In addition, bonds that may be advance refunded must have been issued by the State of Alabama, Louisiana, or Mississippi, or any political subdivision thereof, were outstanding on August 27, 2005, and could not be advance refunded under Code restrictions<sup>27</sup> in effect on that date. Further, to be eligible for the

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<sup>25</sup> Sec. 149(d)(3). Bonds issued before 1986 and pursuant to certain transition rules contained in the Tax Reform Act of 1986 may be advance refunded more than one time in certain cases.

<sup>26</sup> Sec. 149(d)(2). Under present law, certain bonds used to fund facilities located in New York City are permitted one additional advance refunding if such refunding bond is issued before January 1, 2006.

<sup>27</sup> Although section 1400L(e)(4)(A) refers to restrictions on advance refundings under “any provision of law,” no inference should be drawn from the use of different terms.

additional advance refunding, the advance refunding bond must be the only other outstanding bond with respect to the refunded bond.<sup>28</sup>

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. In addition, advance refundings issued under this provision must satisfy the requirements otherwise applicable to advance refunding issues (e.g., redemption requirements and prohibition on abusive transactions).

### **Effective Date**

The proposal is effective for advance refunding bonds issued after the date of enactment and before January 1, 2007.

## **6. Increase the low-income housing credit cap**

### **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

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<sup>28</sup> Thus, at no time after the advance refunding authorized under the provision occurs may there be more than two sets of bonds outstanding.

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.

### **Description of Proposal**

#### **Credit cap**

Under the proposal, the otherwise applicable housing credit ceiling amount is increased for each of the States within the Gulf Opportunity Zone (Alabama, Louisiana, and Mississippi). This increase applies to calendar years 2006, 2007, 2008, and 2009. The additional credit cap for each of the affected States equals three times the otherwise applicable credit cap amount (e.g., \$1.90 for 2006) for the year times the number of such State's residents within the Gulf Opportunity Zone.<sup>29</sup>

#### **Carryover**

At the election of the individual State, the additional credit cap available under this proposal for States within the Gulf Opportunity Zone for calendar years 2006, 2007, 2008, and 2009 may be carried forward for one year, respectively.

#### **Stacking rule**

Within each calendar year, each applicable State must treat the additional credit cap allocable under the proposal to that State as allocated before any other credit cap amounts. Therefore, under the proposal each applicable State 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.

### **Effective Date**

The provisions relating to the increased credit cap, carryover and stacking rule are generally effective for calendar years beginning after 2005 and before 2010.

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<sup>29</sup> 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.

## **7. Special rules for qualified residential rental projects**

### **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 private activity bonds**

Private activity bonds are eligible for tax-exemption if issued for certain purposes permitted by the Code (“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.

#### **Description of Proposal**

Under the proposal, 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. 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 proposal is effective on the date of enactment.

## **8. Additional allocation of new markets tax credit for investments that serve the Gulf Opportunity Zone**

### 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”).<sup>30</sup> 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

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<sup>30</sup> Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, P.L. No. 106-554 (December 21, 2000).

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.<sup>31</sup> 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.

### **Description of Proposal**

The proposal provides 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

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<sup>31</sup> 12. U.S.C. 4702(17) (defines “low-income” for purposes of 12. U.S.C. 4702(20)).

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.

## **9. Five year carryback of net operating losses attributable to Gulf Opportunity Zone losses**

### **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.<sup>32</sup> NOLs generally are first applied to the earliest of the taxable years to which the loss may be carried.<sup>33</sup>

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, 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.<sup>34</sup> This rule applies regardless of whether the taxpayer has an overall net operating loss for the relevant taxable years.

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<sup>32</sup> Sec. 172.

<sup>33</sup> Sec. 172(b)(2).

<sup>34</sup> Sec. 165(i).

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.<sup>35</sup>

## **Description of Proposal**

### **In general**

The proposal 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.

### **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 proposal, the taxpayer is not eligible to also treat the loss as having occurred in the prior taxable year under section 165(i). Similarly, any loss taken into account under the proposal may not also be taken into account under the ten-year carryback of public utility casualty losses which is provided under another proposal in the Chairman's Mark.

### **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

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<sup>35</sup> 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.

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 proposal, 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**

Certain expenses of an employer to temporarily house employees who are employed in the Gulf Opportunity Zone may be included in the eligible NOL, provided the expenses are paid or incurred after August 27, 2005, and before January 1, 2008. 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.

### **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.<sup>36</sup> 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.<sup>37</sup>

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<sup>36</sup> Qualified Gulf Opportunity Zone property is defined under another proposal of the Chairman's Mark, includes eligible property placed in service after August 27, 2005 and on or before December 31, 2007 (December 31, 2008 in the case qualifying nonresidential real property and residential rental property).

<sup>37</sup> 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.<sup>38</sup> 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 proposal.

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 this proposal. Instead, a taxpayer may apply such NOL carrybacks to offset up to 100 percent of AMTI.

## **Effective Date**

The proposal is effective on the date of enactment.

## **10. Treatment of public utility disaster losses**

### **Present Law**

Under present law, 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.<sup>39</sup>

### **Description of Proposal**

The proposal 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.<sup>40</sup>

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<sup>38</sup> 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.

<sup>39</sup> Sec. 165(i).

<sup>40</sup> If the application of this proposal 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 proposal is eligible to file an application for a tentative carryback adjustment<sup>41</sup> 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 proposal, 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 proposal is effective for taxable years ending after August 27, 2005, in which the taxpayer suffers a public utility casualty loss attributable to Hurricane Katrina.

## **11. Special rule for Gulf Opportunity Zone public utility casualty losses**

### **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.<sup>42</sup> NOLs generally are first applied to the earliest of the taxable years to which the loss may be carried.<sup>43</sup>

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<sup>41</sup> Under present law, tentative carryback and refund adjustments are permitted under with respect to net operating losses, net capital losses, and unused business credits (sec. 6411).

<sup>42</sup> Sec. 172.

<sup>43</sup> Sec. 172(b)(2).

### **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.

### **Description of Proposal**

The proposal 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 the 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 Chairman's Mark.

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 proposal is effective for taxable years in which the taxpayer suffers a public utility casualty loss attributable to Hurricane Katrina.

## 12. Increased expensing for reforestation expenditures of small timber producers

### 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.<sup>44</sup> 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.<sup>45</sup> 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.<sup>46</sup>

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.<sup>47</sup>

### Description of Proposal

The proposal doubles, for certain taxpayers, the present-law expensing limit for reforestation expenditures paid or incurred by such taxpayers (i) during the period on or after August 28, 2005, and before January 1, 2007, with respect to qualified timber property any portion of which is located in the Gulf Opportunity Zone, (ii) during the period on or after

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<sup>44</sup> Sec. 194(b).

<sup>45</sup> 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.

<sup>46</sup> Sec. 194(c)(1).

<sup>47</sup> Section 194 applies only to costs required to be capitalized under the general rules of capitalization; costs that could be deducted in the absence of section 194 are not required to be amortized.

September 23, 2005, and before January 1, 2007, 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, 2007, 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.<sup>48</sup>

The proposal applies to taxpayers with aggregate holdings of qualified timber property<sup>49</sup> (including any such holdings deemed held by such taxpayer under applicable attribution rules<sup>50</sup>) which do not exceed 500 acres at any time during the taxable year.

### **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, 2007, 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, 2007, 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, 2007, with respect to qualified timber property any portion of which is located in the Wilma Zone.

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<sup>48</sup> 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).

<sup>49</sup> “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.”

<sup>50</sup> In particular, two or more persons shall be treated as a single person for purposes of determining the taxpayer’s aggregate holdings of qualified timber property and specified timber property if either (i) the relationship between such persons would result in a disallowance of losses under section 267 or 707(b), or (ii) the persons are members of the same controlled group within the meaning of section 194(b)(2)(A). For purposes of this aggregation rule, however, section 267 shall be applied without regard to subsection (b)(1) thereof; thus, an individual taxpayer will not be deemed to own qualified timber property merely because such qualified timber property is owned by a member of the taxpayer’s family (i.e., the taxpayer’s brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants).

### **13. Five-year NOL carryback of certain timber losses**

#### **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.<sup>51</sup> NOLs generally are first applied to the earliest of the taxable years to which the loss may be carried.<sup>52</sup>

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.

#### **Description of Proposal**

The proposal provides that, 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<sup>53</sup> any portion of which is located in the Gulf Opportunity Zone or in the Rita Zone, and if such income and loss is allocable to that portion of the taxpayer’s taxable year which is (1) 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 (2) before January 1, 2007.

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<sup>51</sup> Sec. 172.

<sup>52</sup> Sec. 172(b)(2).

<sup>53</sup> “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 proposal applies to taxpayers with aggregate holdings of qualified timber property (including any such holdings deemed held by such taxpayer under applicable attribution rules<sup>54</sup>) which do not exceed 500 acres at any time during the taxable year. Further, the proposal 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 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.

#### **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.

#### **14. Expensing for certain demolition and clean-up costs**

##### **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.<sup>55</sup> 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

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<sup>54</sup> In particular, two or more persons shall be treated as a single person for purposes of determining the taxpayer's aggregate holdings of qualified timber property and specified timber property if either (i) the relationship between such persons would result in a disallowance of losses under section 267 or 707(b), or (ii) the persons are members of the same controlled group within the meaning of section 194(b)(2)(A). For purposes of this aggregation rule, however, section 267 shall be applied without regard to subsection (b)(1) thereof; thus, an individual taxpayer will not be deemed to own qualified timber property merely because such qualified timber property is owned by a member of the taxpayer's family (i.e., the taxpayer's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants).

<sup>55</sup> Sec. 280B.

damaged. In such cases, the costs are capitalized and added to the taxpayer's basis in the property.<sup>56</sup>

### **Description of Proposal**

Under the proposal, 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 proposal applies to costs paid or incurred on or after August 28, 2005 in taxable years ending on or after such date.

## **15. Extension and expansion to petroleum products of expensing for environmental remediation costs**

### **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.<sup>57</sup> 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<sup>58</sup> as certified by

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<sup>56</sup> See Rev. Rul. 71-161, 1971-1 C.B. 76, permitting the use of clean-up costs as a measure of casualty loss but requiring that such costs be added to the post-casualty basis of the property.

<sup>57</sup> Sec. 198.

<sup>58</sup> 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;

the appropriate State environmental agency (so called “brownfields”).<sup>59</sup> Petroleum products generally are not regarded as hazardous substances for purposes of section 198.<sup>60</sup> Under present law, eligible expenditures are those paid or incurred before January 1, 2006.

### **Description of Proposal**

The proposal 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, the proposal provides that petroleum products are treated as hazardous substances for purposes of applying the expensing provision (as extended) within the Gulf Opportunity Zone.<sup>61</sup> Petroleum products are defined by reference to section 4612(a)(3), and include crude oil, crude oil condensates and natural gasoline.<sup>62</sup> 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. 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 proposal is effective for taxable years ending on or after August 28, 2005, for expenditures paid or incurred on or after that date.

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(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.”

<sup>59</sup> However, sites which are identified on the national priorities list under CERCLA cannot qualify for expensing under section 198.

<sup>60</sup> 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.”

<sup>61</sup> The proposal applies to expenditures paid or incurred on or after August 28, 2005.

<sup>62</sup> 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).

## **B. Modifications to Katrina Emergency Relief**

### **1. Employee retention credit for employers affected by Hurricane Katrina**

#### **Present Law**

Present law 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.

#### **Description of Proposal**

The proposal removes the restriction that prohibits employers with an average of more than 200 employees from claiming the credit.

## **Effective Date**

The proposal is effective as if included in the enactment of section 202 of the Katrina Emergency Tax Relief Act of 2005.

## **2. Special rules for mortgage revenue bonds**

### **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”)<sup>63</sup> 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. 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.

### **Description of Proposal**

The proposal extends the special rules for qualified mortgage bonds provided by KETRA through December 31, 2010.

### **Effective Date**

The proposal is effective on the date of enactment.

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<sup>63</sup> Pub. L. No. 109-73.

## **II. TAX BENEFITS RELATED TO HURRICANES RITA AND WILMA**

### **A. Special Rules for Mortgage Revenue Bonds**

#### **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”)<sup>64</sup> 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. 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.

### **Description of Proposal**

Under the proposal, residences located in the Gulf Opportunity Zone, the Rita Zone, or the Wilma 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.<sup>65</sup> 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 proposal applies to residences financed before January 1, 2011.

### **Effective Date**

The proposal is effective on the date of enactment with respect to residences financed before January 1, 2011.

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<sup>64</sup> Pub. L. No. 109-73.

<sup>65</sup> Thus, the present law rule allowing one-third of the mortgages to be made without regard to any income limits does not apply.

## **B. Special Rules for Use of Retirement Funds**

### **1. Tax-favored withdrawals from retirement plans for relief 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.<sup>66</sup> (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.<sup>67</sup>

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.

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<sup>66</sup> Secs. 402(a), 403(a), 403(b), 408(d), and 457(a).

<sup>67</sup> Sec. 72(t).

## **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.

### **Description of Proposal**

The proposal 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 proposal, 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 proposal is effective on the date of enactment.

## **2. Recontributions of withdrawals for home purchases cancelled due to Hurricanes Rita or 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.<sup>68</sup> 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.<sup>69</sup> 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.

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<sup>68</sup> Secs. 402(a), 403(b), and 408(d).

<sup>69</sup> Sec. 72(t).

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 (Public Law 109-72) 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).

### **Description of Proposal**

The proposal 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 proposal is effective on the date of enactment.

## **3. Loans from qualified plans for relief relating to Hurricanes Rita and 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. 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 (Public Law 109-72) 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.

### **Description of Proposal**

The proposal 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 proposal is effective on the date of enactment.

## **C. Employee Retention Credit for Employers Affected by Hurricanes Rita and Wilma**

### **Present Law**

Present law 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.

### **Description of Proposal**

The proposal extends the retention credit to employers affected by Hurricanes Rita and Wilma and located in the Rita Zone and Wilma Zone, respectively. The proposal also removes the restriction that prohibits employers with an average of more than 200 employees from

claiming the credit. 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 proposal is effective on the date of enactment.

## **D. Temporary Suspension of Limitations on Charitable Contributions**

### **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.<sup>70</sup>

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.

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<sup>70</sup> Sec. 170.

### 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.<sup>71</sup> 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**

Under the Katrina Emergency Tax Relief Act of 2005, 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))

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<sup>71</sup> Sec. 170(d).

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. Corporate taxpayers must substantiate that the contribution is made for this purpose. 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.

The charitable contribution deduction is not treated as an itemized deduction for purposes of the overall limitation on itemized deductions up to the amount of qualified contributions (as defined above) paid during the year.

### **Description of Proposal**

The proposal codifies the provision, enacted as part of the Katrina Emergency Tax Relief Act of 2005 and described above, to suspend temporarily the percentage limitations for qualified contributions.

The proposal also expands the definition of a qualified contribution by a corporation to include contributions by a corporation for relief efforts related to Hurricane Rita and Hurricane Wilma.

### **Effective Date**

The proposal is effective on the date of enactment and applies for purposes of qualified contributions paid during the period beginning on August 28, 2005, and ending on December 31, 2005.

## **E. Suspension of Certain Limitations on Personal Casualty Losses**

### **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**

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.

### **Description of Proposal**

The proposal codifies the rule for Katrina casualty losses and expands it to include losses arising in the Hurricane Rita disaster area on or after September 23, 2005, and attributable to Hurricane Rita, and losses arising in the Hurricane Wilma disaster area on or after October 23, 2005, and attributable to Hurricane Wilma.

### **Effective Date**

The proposal is effective on date of enactment.

## **F. Special Look-Back rule for Determining Earned Income Credit and Refundable Child Credit**

### **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.

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.

### **Description of Proposal**

The proposal codifies and expands the rule governing Katrina elections to permit certain qualified individuals affected by Hurricane Rita and Hurricane Wilma to elect to calculate their earned income credit and refundable child credit using their prior year's earned income. For individuals affected by Hurricane Rita such an election may be made for the taxable year which includes September 23, 2005. For individuals affected by Hurricane Wilma, the election may be made for the taxable year which includes October 23, 2005. Qualified individuals are permitted to make an election with respect to Hurricane Rita or Hurricane Wilma only if their earned income for the relevant taxable year is less than their earned income for the preceding taxable year.

Qualified individuals for purposes of an election related to Hurricane Rita are (1) individuals who on September 23, 2005, had their principal place of abode in the Rita Zone or (2) individuals who on such date had their principal place of abode in the Hurricane Rita disaster area but outside the Rita Zone and were displaced from that residence. Qualified individuals for purposes of an election related to Hurricane Wilma are (1) individuals who on October 23, 2005, had their principal place of abode in the Wilma Zone or (2) individuals who on such date had their principal place of abode in the Hurricane Wilma disaster area but outside the Wilma Zone and were displaced from that residence.

In other respects, an election with respect to Hurricane Rita or Hurricane Wilma is the same as a Katrina election under present law, except that the relevant reference dates are different: September 23, 2005, in the case of Hurricane Rita, and October 23, 2005, in the case of Hurricane Wilma.

### **Effective Date**

The proposal is effective on date of enactment.

## **G. Secretarial Authority to Make Adjustments Regarding Taxpayer and Dependency Status for Taxpayers Affected by Hurricane Rita and Hurricane Wilma**

### **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.

#### **Description of Proposal**

The proposal codifies and 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 proposal is effective with respect to taxable years beginning in 2005 or 2006.

### III. EXTENSION OF EXPIRING PROVISIONS

#### A. Extensions Through 2009

##### 1. Reduced rates for capital gains and dividends of individuals

###### Present Law

###### Capital gains

###### In general

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to \$3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method of depreciation.

###### Tax rates before 2009

Under present law, for taxable years beginning before January 1, 2009, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. Any adjusted net capital gain which otherwise would be taxed at a 10- or 15-percent rate is taxed at a five-percent rate (zero for taxable years beginning after 2007). These rates apply for purposes of both the regular tax and the alternative minimum tax.

Under present law, the "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as

investment income for purposes of determining the investment interest limitation under section 163(d).

The term “28-percent rate gain” means the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof), an amount of gain equal to the amount of gain excluded from gross income under section 1202 (relating to certain small business stock), the net short-term capital loss for the taxable year, and any long-term capital loss carryover to the taxable year.

“Unrecaptured section 1250 gain” means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 (relating to certain property used in a trade or business) applies shall not exceed the net section 1231 gain for the year.

The unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 10- or 15-percent rate is taxed at the otherwise applicable rate.

#### Tax rates after 2008

For taxable years beginning after December 31, 2008, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent. Any adjusted net capital gain which otherwise would be taxed at a 10- or 15-percent rate is taxed at a 10-percent rate.

In addition, any gain from the sale or exchange of property held more than five years that would otherwise have been taxed at the 10-percent rate is taxed at an eight-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, which would otherwise have been taxed at a 20-percent rate is taxed at an 18-percent rate.

The tax rates on 28-percent gain and unrecaptured section 1250 gain are the same as for taxable years beginning before 2009.

### **Dividends**

#### In general

A dividend is the distribution of property made by a corporation to its shareholders out of its after-tax earnings and profits.

### Tax rates before 2009

Under present law, dividends received by an individual from domestic corporations and qualified foreign corporations are taxed at the same rates that apply to net capital gain. This treatment applies for purposes of both the regular tax and the alternative minimum tax. Thus, for taxable years beginning before 2009, dividends received by an individual are taxed at rates of five (zero for taxable years beginning after 2007) and 15 percent.

If a shareholder does not hold a share of stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date (as measured under section 246(c)), dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

Qualified dividend income includes otherwise qualified dividends received from qualified foreign corporations. The term “qualified foreign corporation” includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory and which includes an exchange of information program. In addition, a foreign corporation is treated as a qualified foreign corporation with respect to any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States.

Dividends received from a corporation that is a passive foreign investment company (as defined in section 1297) in either the taxable year of the distribution, or the preceding taxable year, are not qualified dividends.

Special rules apply in determining a taxpayer’s foreign tax credit limitation under section 904 in the case of qualified dividend income. For these purposes, rules similar to the rules of section 904(b)(2)(B) concerning adjustments to the foreign tax credit limitation to reflect any capital gain rate differential will apply to any qualified dividend income.

If a taxpayer receives an extraordinary dividend (within the meaning of section 1059(c)) eligible for the reduced rates with respect to any share of stock, any loss on the sale of the stock is treated as a long-term capital loss to the extent of the dividend.

A dividend is treated as investment income for purposes of determining the amount of deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the reduced rates.

The amount of dividends qualifying for reduced rates that may be paid by a regulated investment company (“RIC”) for any taxable year in which the qualified dividend income received by the company is less than 95 percent of its gross income (as specially computed) may not exceed the sum of (i) the qualified dividend income of the RIC for the taxable year and (ii) the amount of earnings and profits accumulated in a non-RIC taxable year that were distributed by the RIC during the taxable year.

The amount of dividends qualifying for reduced rates that may be paid by a real estate investment trust (“REIT”) for any taxable year may not exceed the sum of (i) the qualified

dividend income of the REIT for the taxable year, (ii) an amount equal to the excess of the income subject to the taxes imposed by section 857(b)(1) and the regulations prescribed under section 337(d) for the preceding taxable year over the amount of these taxes for the preceding taxable year, and (iii) the amount of earnings and profits accumulated in a non-REIT taxable year that were distributed by the REIT during the taxable year.

The reduced rates do not apply to dividends received from an organization that was exempt from tax under section 501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or the preceding taxable year; dividends received from a mutual savings bank that received a deduction under section 591; or deductible dividends paid on employer securities.

Amounts treated as ordinary income on the disposition of certain preferred stock (sec. 306) are treated as dividends for purposes of applying the reduced rates.

Also, the tax rate for the accumulated earnings tax (sec. 531) and the personal holding company tax (sec. 541) is reduced to 15 percent.

The collapsible corporation rules are repealed.

#### Tax rates after 2008

For taxable years beginning after 2008, dividends received by an individual are taxed as ordinary income at rates up to 35 percent.

#### **Description of Proposal**

The proposal extends the lower capital gain and dividend tax rates to taxable years beginning in 2009.

#### **Effective Date**

The proposal applies to taxable years beginning after December 31, 2008.

## **2. Extension of increased expensing for small business**

#### **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.<sup>72</sup> In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct

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<sup>72</sup> 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).

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.

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.<sup>73</sup>

For taxable years beginning in 2008 and thereafter (or before 2003), the following rules apply. A taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. The \$25,000 and \$200,000 amounts are not indexed. 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 (not including off-the-shelf computer software). An expensing election may be revoked only with consent of the Commissioner.<sup>74</sup>

### **Description of Proposal**

The proposal extends for an additional two years the increased amount that a taxpayer may deduct and the other section 179 rules applicable in taxable years beginning before 2008. Thus, under the proposal, these rules are applicable for taxable years beginning before 2010.

### **Effective Date**

The proposal is effective for taxable years beginning after 2007 and before 2010.

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<sup>73</sup> 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. T.D. 9209, July 12, 2005.

<sup>74</sup> Sec. 179(c)(2).

### 3. Credit for elective deferrals and IRA contributions (the “saver’s credit”)

#### Present Law

Eligible taxpayers may claim a nonrefundable credit for qualified retirement savings contributions, referred to as the “saver’s credit.” The maximum annual contribution eligible for the credit is \$2,000. The credit rate depends on the adjusted gross income (“AGI”) of the taxpayer. Taxpayers filing joint returns with AGI of \$50,000 or less, head of household returns of \$37,500 or less, and single returns of \$25,000 or less are eligible for the credit. The AGI limits applicable to single taxpayers apply to married taxpayers filing separate returns. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer’s return.

The credit is available with respect to: (1) elective deferrals to a qualified cash or deferred arrangement (a “section 401(k) plan”), a tax-sheltered annuity (a “section 403(b)” annuity), an eligible deferred compensation arrangement of a State or local government (a “governmental section 457 plan”), a SIMPLE plan, or a simplified employee pension (“SEP”); (2) contributions to a traditional or Roth IRA; and (3) voluntary after-tax employee contributions to a tax-sheltered annuity or qualified retirement plan.

The amount of any contribution eligible for the credit is generally reduced by distributions received by the taxpayer (or by the taxpayer’s spouse if the taxpayer filed a joint return with the spouse) from any plan or IRA to which eligible contributions can be made during the taxable year for which the credit is claimed, the two taxable years prior to the year the credit is claimed, and during the period after the end of the taxable year for which the credit is claimed and prior to the due date for filing the taxpayer’s return for the year. Distributions that are rolled over to another retirement plan do not affect the credit.

The table below shows the credit rates based on AGI.

**Table.—Credit Rates Based on AGI**

<i>Joint Filers</i>	<i>Heads of Household</i>	<i>All Other Filers</i>	<i>Credit Rate</i>
\$0-\$30,000	\$0-\$22,500	\$0-\$15,000	50 percent
\$30,001-\$32,500	\$22,501-\$24,375	\$15,001-\$16,250	20 percent
\$32,501-\$50,000	\$24,376-\$37,500	\$16,251-\$25,000	10 percent
Over \$50,000	Over \$37,500	Over \$25,000	0 percent

The saver's credit does not apply for taxable years beginning after December 31, 2006.<sup>75</sup>

### **Description of Proposal**

The proposal extends the saver's credit through December 31, 2009.

### **Effective Date**

The proposal is effective on the date of enactment.

## **4. Above-the-line deduction for higher education expenses**

### **Present Law**

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

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

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

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<sup>75</sup> The saver's credit was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), Pub. L. No. 107-16. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

For taxable years beginning in 2004 and 2005, the maximum deduction is \$4,000 for an individual whose adjusted gross income for the taxable year does not exceed \$65,000 (\$130,000 in the case of a joint return), or \$2,000 for other individuals whose adjusted gross income does not exceed \$80,000 (\$160,000 in the case of a joint return). No deduction is allowed for an individual whose adjusted gross income exceeds the relevant adjusted gross income limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2005.

#### **Description of Proposal**

The proposal extends the tuition deduction for four years, through December 31, 2009.

#### **Effective Date**

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

## **B. One-Year Extensions**

### **1. Election to deduct State and local general sales taxes**

#### **Present Law**

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

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

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

#### **Description of Proposal**

The present-law provision allowing taxpayers to elect to deduct State and local sales taxes in lieu of State and local income taxes is extended for one year (through December 31, 2006).

### **Effective Date**

The proposal applies to taxable years beginning after December 31, 2005.

## **2. Extend alternative minimum tax exemption amount for individuals**

### **Present Law**

Present law imposes an alternative minimum tax. The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed \$175,000 (\$87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments.

The exemption amount is: (1) \$45,000 (\$58,000 for taxable years beginning before 2006) in the case of married individuals filing a joint return and surviving spouses; (2) \$33,750 (\$40,250 for taxable years beginning before 2006) in the case of other unmarried individuals; (3) \$22,500 (\$29,000 for taxable years beginning before 2006) in the case of married individuals filing a separate return; and (4) \$22,500 in the case of an estate or trust. The exemption amount is phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) \$150,000 in the case of married individuals filing a joint return and surviving spouses, (2) \$112,500 in the case of other unmarried individuals, and (3) \$75,000 in the case of married individuals filing separate returns, an estate, or a trust. These amounts are not indexed for inflation.

### **Description of Proposal**

Under the proposal, the increased alternative minimum tax exemption amounts apply to taxable years beginning in 2006.

### **Effective Date**

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

## **3. Allowance of nonrefundable personal credits against regular and alternative minimum tax liability**

### **Present Law**

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, and the D.C. first-time homebuyer credit). The Energy Tax

Incentives Act of 2005 enacted, effective for 2006, nonrefundable tax credits for alternative motor vehicles, and alternative motor vehicle refueling property.<sup>76</sup>

For taxable years beginning in 2005, the nonrefundable personal tax credits are allowed to the extent of the full amount of the individual's regular tax and alternative minimum tax.

For taxable years beginning after 2005, the nonrefundable personal tax credits (other than the adoption credit, child credit and saver's credit) are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. The adoption credit, child credit, and saver's credit are allowed to the full extent of the individual's regular tax and alternative minimum tax.

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed \$175,000 (\$87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments.

The exemption amount is: (1) \$45,000 (\$58,000 for taxable years beginning before 2006) in the case of married individuals filing a joint return and surviving spouses; (2) \$33,750 (\$40,250 for taxable years beginning before 2006) in the case of other unmarried individuals; (3) \$22,500 (\$29,000 for taxable years beginning before 2006) in the case of married individuals filing a separate return; and (4) \$22,500 in the case of an estate or trust. The exemption amount is phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) \$150,000 in the case of married individuals filing a joint return and surviving spouses, (2) \$112,500 in the case of other unmarried individuals, and (3) \$75,000 in the case of married individuals filing separate returns, an estate, or a trust. These amounts are not indexed for inflation.

### **Description of Proposal**

The nonrefundable personal tax credits, and the nonbusiness portion of the tax credits for alternative motor vehicles and alternative motor vehicle refueling property, are allowed to the full extent of the individual's regular tax and alternative minimum tax for taxable years beginning in 2006.

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<sup>76</sup> The credits for alternative motor vehicles and alternative motor vehicle refueling property apply to business as well as nonbusiness use. The portion of these credits relating to nonbusiness use is subject to the same tax liability limitation, beginning in 2006, as the nonrefundable personal tax credits (other than the adoption credit, child credit, and saver's credit).

## **Effective Date**

The proposal applies to taxable years beginning after December 31, 2005.

### **4. Research credit**

#### **Present Law**

##### **General rule**

Section 41 provides for a research credit equal to 20 percent of the amount by which a taxpayer's qualified research expenses for a taxable year exceed its base amount for that year. The research credit is scheduled to expire and generally will not apply to amounts paid or incurred after December 31, 2005.

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

##### **Computation of allowable credit**

Except for certain university basic research payments made by corporations, the research credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) are assigned a fixed-base percentage of three percent.

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

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

### **Alternative incremental research credit regime**

Taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative incremental credit regime, a credit rate of 2.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equals one percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent. An election to be subject to this alternative incremental credit regime may be made for any taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury.

### **Eligible expenses**

Qualified research expenses eligible for the research credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).

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

### **Relation to deduction**

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures paid or incurred in connection with a trade or business,

notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized. However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research credit determined for the taxable year (Sec. 280C(c)). Taxpayers may alternatively elect to claim a reduced research credit amount under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

### **Description of Proposal**

The present-law provision is extended for one year (through December 31, 2006). However, research credit amounts earned in 2006 may not be taken into account in computing estimated tax payments required to be paid for taxable years beginning in 2006.

### **Effective Date**

The proposal is effective on the date of enactment.

## **5. Parity in the application of certain limits to mental health benefits**

### **Present Law**

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

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

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

The Code, ERISA and PHSA mental health parity requirements are scheduled to expire with respect to benefits for services furnished after December 31, 2005.

## **Description of Proposal**

The excise tax under the Code is extended for one year (through December 31, 2006).

### **Effective Date**

The proposal is effective on the date of enactment.

## **6. Work Opportunity Tax credit and Welfare-To-Work Tax credit**

### **Present Law**

#### **Work opportunity tax credit**

##### Targeted groups eligible for the credit

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

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

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

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

##### Qualified wages

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

##### Calculation of the credit

The credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of \$6,000) attributable to service rendered by a member of a targeted group during the

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

#### Minimum employment period

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

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

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

#### Other rules

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

#### Expiration

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

### **Welfare-to-work tax credit**

#### Targeted group eligible for the credit

The welfare-to-work tax credit is available on an elective basis to employers of qualified long-term family assistance recipients. Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of the welfare-to-work tax credit) if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either Federal or State time limits, if they are hired within 2 years after the Federal or State time limits made the family ineligible for family assistance.

#### Qualified wages

Qualified wages for purposes of the welfare-to-work tax credit are defined more broadly than the work opportunity tax credit. Unlike the definition of wages for the work opportunity tax

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

#### Calculation of the credit

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

#### Minimum employment period

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

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

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

#### Other rules

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

#### Expiration

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

### **Description of Proposal**

#### **In general**

Combines the work opportunity and welfare-to-work tax credits and extends the combined credit for one year. The welfare-to-work credit is repealed.

### **Targeted groups eligible for the combined credit**

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

The proposal raises the age limit for the high-risk youth category to include individuals aged 18 but not aged 40 on the hiring date. The proposal also renames the high-risk youth category to be the designated community resident category.

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

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

### **Qualified wages**

Qualified first-year wages for the eight work opportunity tax credit categories remain capped at \$6,000 (\$3,000 for qualified summer youth employees). No credit is allowed for second-year wages. In the case of long-term family assistance recipients, the cap is \$10,000 for both qualified first-year wages and qualified second-year wages. The combined credit follows the work opportunity tax credit definition of wages which does not include amounts paid by the employer for: (1) educational assistance excludable under a section 127 program (or that would be excludable but for the expiration of sec. 127); (2) health plan coverage for the employee, but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129. For all targeted groups, the employer's deduction for wages is reduced by the amount of the credit.

### **Calculation of the credit**

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

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

### **Minimum employment period**

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

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

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

### **Effective date**

The proposal is effective for wages paid or incurred to a qualified individual who begins work for an employer after December 31, 2005, and before January 1, 2007.

## **7. Qualified zone academy bonds**

### **Present Law**

#### **Tax-exempt bonds**

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

#### **Qualified zone academy bonds**

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

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

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

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

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

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

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

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

### **Description of Proposal**

The present-law provision is extended for one year (through December 31, 2006).

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

The proposal also imposes new spending requirements for qualified zone academy bonds. An issuer of qualified zone academy bonds must reasonably expect to and actually spend 95

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

Under the proposal, the contribution received from private entities must be in the form of cash or cash equivalents, rather than property or services as permitted under present law. In addition, issuers of qualified zone academy bonds are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds.

### **Effective Date**

The proposal applies to bonds issued after December 31, 2005.

## **8. Suspend limitation on rate of rum excise tax cover over to Puerto Rico and Virgin Islands**

### **Present Law**

A \$13.50 per proof gallon<sup>77</sup> excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States.<sup>78</sup> The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).<sup>79</sup>

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.<sup>80</sup> The amount of the cover over is limited under Code section 7652(f) to \$10.50 per proof gallon (\$13.25 per proof gallon during the period July 1, 1999 through December 31, 2005).

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United

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<sup>77</sup> A proof gallon is a liquid gallon consisting of 50 percent alcohol. *See* sec. 5002(a)(10) and (11).

<sup>78</sup> Sec. 5001(a)(1).

<sup>79</sup> Secs. 5062(b), 7653(b) and (c).

<sup>80</sup> Secs. 7652(a)(3), (b)(3), and (e)(1). One percent of the amount of excise tax collected from imports into the United States of articles produced in the Virgin Islands is retained by the United States under section 7652(b)(3).

States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.<sup>81</sup> Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.<sup>82</sup> All of the amounts covered over are subject to the limitation.

### **Description of Proposal**

The proposal extends the increased \$13.25 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. Under the proposal, the cover over amount of \$13.25 per proof gallon is extended for rum brought into the United States after December 31, 2005 and before January 1, 2007. After December 31, 2006, the cover over amount reverts to \$10.50 per proof gallon.

### **Effective Date**

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

## **9. Deduction for corporate donations of computer technology and equipment**

### **Present Law**

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

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

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets standards of functionality and suitability as established by

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<sup>81</sup> Sec. 7652(e)(2).

<sup>82</sup> Secs. 7652(a)(3), (b)(3), and (e)(1).

the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed the property, not later than the date construction of the property is substantially completed. The original use of the property must be by the donor or the donee, and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed by the taxpayer, the rules applicable to qualified research contributions apply. That is, property is considered constructed by the taxpayer only if the cost of the parts used in the construction of the property (other than parts manufactured by the taxpayer or a related person) does not exceed 50 percent of the taxpayer's basis in the property. Contributions may be made to private foundations under certain conditions.

### **Description of Proposal**

The present-law provision is extended for one year to apply to contributions made during any taxable year beginning after December 31, 2005, and before January 1, 2007.

### **Effective Date**

The proposal is effective on the date of enactment.

## **10. Above-the-line deduction for certain expenses of elementary and secondary school teachers**

### **Present Law**

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

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

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

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

### **Description of Proposal**

The present-law provision is extended for one year, through December 31, 2006.

### **Effective Date**

The proposal is effective for expenses paid or incurred in taxable years beginning after December 31, 2005.

## **11. Expensing of brownfields remediation costs**

### **Present Law**

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

Under Code section 198, taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property, which would otherwise be allocated to the site under the principles set forth in *Commissioner v. Idaho Power Co.* and section 263A, are treated as qualified environmental remediation expenditures.

A “qualified contaminated site” (a so-called “brownfield”) generally is any property that is held for use in a trade or business, for the production of income, or as inventory and is certified by the appropriate State environmental agency to be an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance. Both urban and rural property may qualify. However, sites that are identified on the national priorities list under the

Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (“CERCLA”) cannot qualify as targeted areas. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use.

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

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

#### **Description of Proposal**

The present-law provision is extended for one year (through December 31, 2006).

#### **Effective Date**

The proposal applies to expenditures paid or incurred after December 31, 2005.

### **12. Tax incentives for investment in the District of Columbia**

#### **Present Law**

##### **In general**

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

##### **Wage credit**

A 20-percent wage credit is available to employers for the first \$15,000 of qualified wages paid to each employee (i.e., a maximum credit of \$3,000 with respect to each qualified

employee) who (1) is a resident of the D.C. Zone, and (2) performs substantially all employment services within the D.C. Zone in a trade or business of the employer.

Wages paid to a qualified employee who earns more than \$15,000 are eligible for the wage credit (although only the first \$15,000 of wages is eligible for the credit). The wage credit is available with respect to a qualified full-time or part-time employee (employed for at least 90 days), regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the D.C. Zone may claim the wage credit, regardless of whether the employer meets the definition of a “D.C. Zone business.”<sup>83</sup>

An employer’s deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.<sup>84</sup> Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer’s work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A.<sup>85</sup> In addition, the \$15,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.<sup>86</sup> The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.<sup>87</sup>

### **Section 179 expensing**

In general, a D.C. Zone business is allowed an additional \$35,000 of section 179 expensing for qualifying property placed in service by a D.C. Zone business.<sup>88</sup> The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified zone property placed in service during the year by the taxpayer exceeds \$200,000 (\$400,000 for taxable years beginning after 2002 and before 2008). The term “qualified zone property” is defined as depreciable tangible property (including buildings), provided that (1) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (2) the original use of the property in the D.C. Zone commences with the taxpayer, and (3) substantially all of the use of the property is in the D.C. Zone in the active conduct of a trade or

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<sup>83</sup> However, the wage credit is not available for wages paid in connection with certain business activities described in section 144(c)(6)(B) or certain farming activities. In addition, wages are not eligible for the wage credit if paid to (1) a person who owns more than five percent of the stock (or capital or profits interests) of the employer, (2) certain relatives of the employer, or (3) if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business.

<sup>84</sup> Sec. 280C(a).

<sup>85</sup> Secs. 1400H(a), 1396(c)(3)(A) and 51A(d)(2).

<sup>86</sup> Secs. 1400H(a), 1396(c)(3)(B) and 51A(d)(2).

<sup>87</sup> Sec. 38(c)(2).

<sup>88</sup> Sec. 1397A.

business by the taxpayer.<sup>89</sup> Special rules are provided in the case of property that is substantially renovated by the taxpayer.

### **Tax-exempt financing**

A qualified D.C. Zone business is permitted to borrow proceeds from tax-exempt qualified enterprise zone facility bonds (as defined in section 1394) issued by the District of Columbia.<sup>90</sup> Such bonds are subject to the District of Columbia's annual private activity bond volume limitation. Generally, qualified enterprise zone facility bonds for the District of Columbia are bonds 95 percent or more of the net proceeds of which are used to finance certain facilities within the D.C. Zone. The aggregate face amount of all outstanding qualified enterprise zone facility bonds per qualified D.C. Zone business may not exceed \$15 million and may be issued only while the D.C. Zone designation is in effect.

### **Zero-percent capital gains**

A zero-percent capital gains rate applies to capital gains from the sale of certain qualified D.C. Zone assets held for more than five years.<sup>91</sup> In general, a qualified "D.C. Zone asset" means stock or partnership interests held in, or tangible property held by, a D.C. Zone business. For purposes of the zero-percent capital gains rate, the D.C. Enterprise Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than 10 percent.

In general, gain eligible for the zero-percent tax rate means gain from the sale or exchange of a qualified D.C. Zone asset that is (1) a capital asset or property used in the trade or business as defined in section 1231(b), and (2) acquired before January 1, 2006. Gain that is attributable to real property, or to intangible assets, qualifies for the zero-percent rate, provided that such real property or intangible asset is an integral part of a qualified D.C. Zone business.<sup>92</sup> However, no gain attributable to periods before January 1, 1998, and after December 31, 2010, is qualified capital gain.

### **District of Columbia homebuyer tax credit**

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to \$5,000 of the amount of the purchase price. The \$5,000 maximum credit applies both to individuals and married couples. Married individuals filing

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<sup>89</sup> Sec. 1397D.

<sup>90</sup> Sec. 1400A.

<sup>91</sup> Sec. 1400B.

<sup>92</sup> However, sole proprietorships and other taxpayers selling assets directly cannot claim the zero-percent rate on capital gain from the sale of any intangible property (i.e., the integrally related test does not apply).

separately can claim a maximum credit of \$2,500 each. The credit phases out for individual taxpayers with adjusted gross income between \$70,000 and \$90,000 (\$110,000-\$130,000 for joint filers). For purposes of eligibility, “first-time homebuyer” means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one-year period ending on the date of the purchase of the residence to which the credit applies. The credit is scheduled to expire for residences purchased after December 31, 2005.<sup>93</sup>

### **Description of Proposal**

The proposal extends the designation of the D.C. Zone for one year (through December 31, 2006), thus extending the wage credit and section 179 expensing for one year.

The proposal extends the tax-exempt financing for one year, applying to bonds issued during the period beginning on January 1, 1998, and ending on December 31, 2006.

The proposal extends the zero-percent capital gains rate applicable to capital gains from the sale of certain qualified D.C. Zone assets for one year.

The proposal extends the first-time homebuyer credit for one year, through December 31, 2006.

### **Effective Date**

The proposal is effective on the date of enactment.

## **13. Indian employment tax credit**

### **Present Law**

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

Qualified wages means wages paid or incurred by an employer for services performed by a qualified employee. A qualified employee means any employee who is an enrolled member of an Indian tribe or the spouse of an enrolled member of an Indian tribe, who performs

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<sup>93</sup> Sec. 1400C(i).

substantially all of the services within an Indian reservation, and whose principal place of abode while performing such services is on or near the reservation in which the services are performed.

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

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

#### **Description of Proposal**

The present-law provision is extended for one year (through December 31, 2006).

#### **Effective Date**

The proposal is effective on the date of enactment.

### **14. Accelerated depreciation for business property on an Indian reservation**

#### **Present Law**

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

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

“Qualified Indian reservation property” eligible for accelerated depreciation includes property which is (1) used by the taxpayer predominantly in the active conduct of a trade or

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

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

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax. The accelerated depreciation for Indian reservations is available with respect to property placed in service on or after January 1, 1994, and before January 1, 2006.

### **Description of Proposal**

The present-law provision is extended for one year (to apply to property placed in service through December 31, 2006).

### **Effective Date**

The proposal is effective on the date of enactment.

## **15. Fifteen-year straight-line cost recovery for qualified leasehold improvements and qualified restaurant improvements**

### **Present Law**

#### **In general**

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

months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

### **Depreciation of leasehold improvements**

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

### **Qualified leasehold improvement property**

Section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2006. Qualified leasehold improvement property is recovered using the straight-line method. Leasehold improvements placed in service in 2006 and later will be subject to the general rules described above.

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

### **Qualified restaurant property**

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

**Description of Proposal**

The present-law provisions are extended for one year (through December 31, 2006).

**Effective Date**

The proposal applies to property placed in service after December 31, 2005.

## **C. Application of EGTRRA Sunset**

### **Present Law**

The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) made a number of changes to the Federal tax laws. In order to comply with reconciliation procedures under the Congressional Budget Act of 1974 (e.g., section 313 of the Budget Act, under which a point of order may be lodged in the Senate), EGTRRA included a “sunset” provision, pursuant to which the provisions of EGTRRA expire at the end of 2010. Specifically, EGTRRA’s provisions do not apply for taxable, plan, or limitation years beginning after December 31, 2010, or to estates of decedents dying after, or gifts or generation-skipping transfers made after, December 31, 2010. EGTRRA provides that, as of the effective date of the sunset, both the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (“ERISA”) will be applied as though EGTRRA had never been enacted.

Certain provisions contained in EGTRRA expire before the general sunset date of 2010.

### **Description of Proposal**

The proposal clarifies that the EGTRRA sunset continues to apply to any of the provisions of the proposal to the same extent and in the same manner as the sunset applies to provision of EGTRRA to which the proposal relates.

### **Effective Date**

The proposal is effective on the date of enactment.

## **IV. REVENUE OFFSET PROVISIONS**

### **A. Provisions Designed to Curtail Tax Shelters**

#### **1. Understatement of taxpayer's liability by income tax return preparer**

##### **Present Law**

An income tax return preparer who prepares a return with respect to which there is an understatement of tax that is due to an undisclosed position for which there was not a realistic possibility of being sustained on its merits, or a frivolous position, is liable for a penalty of \$250, provided the preparer knew or reasonably should have known of the position. An income tax return preparer who prepares a return and engages in specified willful or reckless conduct with respect to preparing such a return is liable for a penalty of \$1,000.

##### **Description of Proposal**

The proposal alters the standards of conduct that must be met to avoid imposition of the first penalty by replacing the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The proposal also replaces the not-frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position, increases the present-law \$250 penalty to \$1,000, and increases the present-law \$1,000 penalty to \$5,000.

##### **Effective date**

The proposal is effective for documents prepared after the date of enactment.

#### **2. Modifications of suspension of interest and penalties where Internal Revenue Service fails to contact taxpayer**

##### **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<sup>94</sup> 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. 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.

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<sup>94</sup> If the return is filed before the due date, for this purpose it is considered to have been filed on the due date.

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.

### **Description of Proposal**

Under the proposal, 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, as of July 9, 2005 (in the case of an undisclosed reportable transaction) or May 9, 2005 (in the case of a listed transaction): (1) the taxpayer is participating in (and eventually reaches resolution via) a published IRS settlement initiative with respect to the transaction, or (2) the year in which the underpayment occurred is barred by the statute of limitations as of July 9, 2005 (in the case of an undisclosed reportable transaction) or May 9, 2005 (in the case of a listed transaction).

The proposal 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 proposal 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 July 29, 2005.

## **3. Frivolous tax submissions**

### **Present Law**

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of \$500 imposed by the IRS (sec. 6702). The Code also permits the Tax Court<sup>95</sup> to impose a penalty of up to \$25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

### **Description of Proposal**

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

The proposal also modifies present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions

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<sup>95</sup> Because in general the Tax Court is the only forum available to taxpayers that does not require pre-payment, it deals with most of the frivolous, groundless, or dilatory arguments raised in tax cases.

to which this proposal applies are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the proposal permits the IRS to disregard such requests. Second, the proposal permits the IRS to impose a penalty of up to \$5,000 for such requests, unless the taxpayer withdraws the request after being given an opportunity to do so.

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

#### **Effective Date**

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

## B. Economic Substance Doctrine

### 1. Clarification of the economic substance doctrine

#### Present Law

##### In general

The Code provides specific rules regarding the computation of taxable income, including the amount, timing, source, and character of items of income, gain, loss and deduction. These rules are designed to provide for the computation of taxable income in a manner that provides for a degree of specificity to both taxpayers and the government. Taxpayers generally may plan their transactions in reliance on these rules to determine the federal income tax consequences arising from the transactions.

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of tax motivated transactions, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. Although these doctrines serve an important role in the administration of the tax system, invocation of these doctrines can be seen as at odds with an objective, “rule-based” system of taxation. Nonetheless, courts have applied the doctrines to deny tax benefits arising from certain transactions.<sup>96</sup>

A common-law doctrine applied with increasing frequency is the “economic substance” doctrine. In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer’s economic position other than a purported reduction in federal income tax.<sup>97</sup>

##### Economic substance doctrine

Courts generally deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of tax considerations – notwithstanding that the purported activity actually occurred. The tax court has described the doctrine as follows:

The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to

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<sup>96</sup> See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff’g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999).

<sup>97</sup> Closely related doctrines also applied by the courts (sometimes interchangeable with the economic substance doctrine) include the “sham transaction doctrine” and the “business purpose doctrine”. See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960) (denying interest deductions on a “sham transaction” whose only purpose was to create the deductions).

claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.<sup>98</sup>

### Business purpose doctrine

Another common law doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine. The business purpose test is a subjective inquiry into the motives of the taxpayer – that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.<sup>99</sup>

### Application by the courts

#### Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine.<sup>100</sup> Some courts apply a conjunctive test that requires a taxpayer to establish the presence of both economic substance (i.e., the objective component) and business purpose (i.e., the subjective component) in order for the transaction to survive judicial scrutiny.<sup>101</sup> A narrower approach used by some courts is to conclude that either a business purpose or economic substance is sufficient to respect the transaction.<sup>102</sup> A third approach regards economic

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<sup>98</sup> *ACM Partnership v. Commissioner*, 73 T.C.M. at 2215.

<sup>99</sup> *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

<sup>100</sup> “The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify.” *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9<sup>th</sup> Cir. 1988).

<sup>101</sup> See, e.g., *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6<sup>th</sup> Cir. 1993) (“The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.”).

<sup>102</sup> See, e.g., *Rice’s Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4<sup>th</sup> Cir. 1985) (“To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists.”); *IES Industries v. United States*, 253 F.3d 350, 358 (8<sup>th</sup> Cir. 2001) (“In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose out of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists (the economic substance test).”). As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied interchangeably. For a more detailed discussion of the sham transaction doctrine, see, e.g., Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section*

substance and business purpose as “simply more precise factors to consider” in determining whether a transaction has any practical economic effects other than the creation of tax benefits.<sup>103</sup>

### Profit potential

There also is a lack of uniformity regarding the necessity and level of profit potential necessary to establish economic substance. Since the time of *Gregory v. Helvering*,<sup>104</sup> several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.<sup>105</sup> In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.<sup>106</sup> Under this analysis, the taxpayer’s profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a “reasonable possibility of profit” from the transaction existed apart from the tax benefits.<sup>107</sup> In these cases, in assessing whether a reasonable possibility of profit exists, it is sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits.

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*3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99) at 182.

<sup>103</sup> See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d at 247; *James v. Commissioner*, 899 F.2d 905, 908 (10<sup>th</sup> Cir. 1995); *Sacks v. Commissioner*, 69 F.3d 982, 985 (9<sup>th</sup> Cir. 1995) (“Instead, the consideration of business purpose and economic substance are simply more precise factors to consider . . . We have repeatedly and carefully noted that this formulation cannot be used as a ‘rigid two-step analysis’.”).

<sup>104</sup> 293 U.S. 465 (1935).

<sup>105</sup> See, e.g., *Knetsch*, 364 U.S. at 361; *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance); *Ginsburg v. Commissioner*, 35 T.C.M. (CCH) 860 (1976) (holding that a leveraged cattle-breeding program lacked economic substance).

<sup>106</sup> See, e.g., *Goldstein v. Commissioner*, 364 F.2d at 739-40 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); *Sheldon v. Commissioner*, 94 T.C. 738, 768 (1990) (stating, “potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions”).

<sup>107</sup> See, e.g., *Rice’s Toyota World v. Commissioner*, 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v. Commissioner*, 277 F.3d at 781 (applied the same test, citing *Rice’s Toyota World*); *IES Industries v. United States*, 253 F.3d at 354 (the application of the objective economic substance test involves determining whether there was a “reasonable possibility of profit . . . apart from tax benefits.”).

## **Description of Proposal**

The proposal clarifies and enhances the application of the economic substance doctrine. The proposal provides that, in a case in which a court determines that the economic substance doctrine is relevant to a transaction (or a series of transactions), such transaction (or series of transactions) has economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.<sup>108</sup>

The proposal does not change current law standards used by courts in determining when to utilize an economic substance analysis.<sup>109</sup> Also, the proposal does not alter the court's ability to aggregate, disaggregate or otherwise recharacterize a transaction when applying the doctrine.<sup>110</sup> The proposal provides a uniform definition of economic substance, but does not alter the flexibility of the courts in other respects.

### **Conjunctive analysis**

The proposal clarifies that the economic substance doctrine involves a conjunctive analysis – there must be an objective inquiry regarding the effects of the transaction on the taxpayer's economic position, as well as a subjective inquiry regarding the taxpayer's motives for engaging in the transaction. Under the proposal, a transaction must satisfy both tests – i.e., it must change in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and the taxpayer must have a substantial non-tax purpose for entering into such transaction (and the transaction is a reasonable means of accomplishing such purpose) – in order to satisfy the economic substance doctrine. This clarification eliminates the disparity that exists among the circuits regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.

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<sup>108</sup> If the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this provision.

<sup>109</sup> See, e.g., Treas. Reg. sec. 1.269-2, stating that characteristic of circumstances in which a deduction otherwise allowed will be disallowed are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate.

<sup>110</sup> See, e.g., *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) (“A given result at the end of a straight path is not made a different result because reached by following a devious path.”).

## **Non-tax business purpose**

The proposal provides that a taxpayer's non-tax purpose for entering into a transaction (the second prong in the analysis) must be "substantial," and that the transaction must be "a reasonable means" of accomplishing such purpose. Under this formulation, the non-tax purpose for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities.<sup>111</sup>

In determining whether a taxpayer has a substantial non-tax business purpose, an objective of achieving a favorable accounting treatment for financial reporting purposes will not be treated as having a substantial non-tax purpose.<sup>112</sup> Furthermore, a transaction that is expected to increase financial accounting income as a result of generating tax deductions or losses without a corresponding financial accounting charge (i.e., a permanent book-tax difference)<sup>113</sup> should not

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<sup>111</sup> See, e.g., Treas. Reg. sec. 1.269-2(b) (stating that a distortion of tax liability indicating the principal purpose of tax evasion or avoidance might be evidenced by the fact that "the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer"). Similarly, in *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189 (1997), the court stated:

Key to [the determination of whether a transaction has economic substance] is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. [citations omitted]

See also Martin McMahon Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, 94 Tax Notes 1017, 1023 (Feb. 25, 2002) (advocates "confining the most rigorous application of business purpose, economic substance, and purposive activity tests to transactions outside the ordinary course of the taxpayer's business -- those transactions that do not appear to contribute to any business activity or objective that the taxpayer may have had apart from tax planning but are merely loss generators."); Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. Rev. 131, 140 (Winter 2001) ("The message is that you can pick up tax gold if you find it in the street while going about your business, but you cannot go hunting for it.").

<sup>112</sup> However, if the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, such tax benefits should not be disallowed solely because the transaction results in a favorable accounting treatment. An example is the repealed foreign sales corporation rules.

<sup>113</sup> This includes tax deductions or losses that are anticipated to be recognized in a period subsequent to the period the financial accounting benefit is recognized. For example, FAS 109 in some cases permits the recognition of financial accounting benefits prior to the period in which the tax benefits are recognized for income tax purposes.

be considered to have a substantial non-tax purpose unless a substantial non-tax purpose exists apart from the financial accounting benefits.<sup>114</sup>

By requiring that a transaction be a “reasonable means” of accomplishing its non-tax purpose, the proposal reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.<sup>115</sup>

### **Profit potential**

Under the proposal, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer’s economic position; the proposal merely sets forth a minimum threshold of profit potential if that test is relied on to demonstrate a meaningful change in economic position. If a taxpayer relies on a profit potential, however, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.<sup>116</sup> Moreover, the profit potential must exceed a risk-free rate of return. In addition, in determining pre-tax profit, fees and other transaction expenses and foreign taxes are treated as expenses.

In applying the profit potential test to a lessor of tangible property, depreciation, applicable tax credits (such as the rehabilitation tax credit and the low income housing tax credit), and any other deduction as provided in guidance by the Secretary are not taken into account in measuring tax benefits.

### **Transactions with tax-indifferent parties**

The proposal also provides special rules for transactions with tax-indifferent parties. For this purpose, a tax-indifferent party means any person or entity not subject to Federal income tax, or any person to whom an item would have no substantial impact on its income tax liability. Under these rules, the form of a financing transaction will not be respected if the present value of the tax deductions to be claimed is substantially in excess of the present value of the anticipated economic returns to the lender. Also, the form of a transaction with a tax-indifferent party will

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<sup>114</sup> Claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement. See, e.g., *American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) (“AEP’s intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings ‘were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,’”) (citing *Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)).

<sup>115</sup> See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

<sup>116</sup> Thus, a “reasonable possibility of profit” will not be sufficient to establish that a transaction has economic substance.

not be respected if it results in an allocation of income or gain to the tax-indifferent party in excess of the tax-indifferent party's economic gain or income or if the transaction results in the shifting of basis on account of overstating the income or gain of the tax-indifferent party.

### **Other rules**

The Secretary may prescribe regulations which provide (1) exemptions from the application of the proposal, and (2) other rules as may be necessary or appropriate to carry out the purposes of the proposal.

No inference is intended as to the proper application of the economic substance doctrine under present law. In addition, except with respect to the economic substance doctrine, the bill shall not be construed as altering or supplanting any other common law doctrine (including the sham transaction doctrine), and the Senate amendment shall be construed as being additive to any such other doctrine.

### **Effective Date**

The proposal applies to transactions entered into after the date of enactment.

## **2. Penalty for understatements attributable to transactions lacking economic substance, etc.**

### **Present Law**

#### **General accuracy-related penalty**

An accuracy-related penalty under section 6662 applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (or, in the case of corporations, by the lesser of (a) 10 percent of the correct tax (or \$10,000 if greater) or (b) \$10 million), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.<sup>117</sup> Except in the case of tax shelters,<sup>118</sup> the amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. The Treasury Secretary may

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<sup>117</sup> Sec. 6662.

<sup>118</sup> A tax shelter is defined for this purpose as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, other entity, plan, or arrangement is the avoidance or evasion of Federal income tax. Sec. 6662(d)(2)(C).

prescribe a list of positions which the Secretary believes do not meet the requirements for substantial authority under this provision.

The section 6662 penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was “reasonable cause” for the underpayment and that the taxpayer acted in good faith.<sup>119</sup> The relevant regulations provide that reasonable cause exists where the taxpayer “reasonably relies in good faith on an opinion based on a professional tax advisor’s analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged” by the IRS.<sup>120</sup>

### **Listed transactions and reportable avoidance transactions**

#### In general

A separate accuracy-related penalty under section 6662A applies to “listed transactions” and to other “reportable transactions” with a significant tax avoidance purpose (hereinafter referred to as a “reportable avoidance transaction”). The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

Both listed transactions and reportable transactions are allowed to be described by the Treasury department under section 6707A(c), which imposes a penalty for failure adequately to report such transactions under section 6011. A reportable transaction is defined as one that the Treasury Secretary determines is required to be disclosed because it is determined to have a potential for tax avoidance or evasion.<sup>121</sup> A listed transaction is defined as a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of the reporting disclosure requirements.<sup>122</sup>

#### Disclosed transactions

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction.<sup>123</sup> The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the “strengthened reasonable cause exception”), which is described below. The strengthened reasonable cause exception is available

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<sup>119</sup> Sec. 6664(c).

<sup>120</sup> Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

<sup>121</sup> Sec. 6707A(c)(1).

<sup>122</sup> Sec. 6707A(c)(2).

<sup>123</sup> Sec. 6662A(a).

only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

#### Undisclosed transactions

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a strict-liability penalty generally applies), and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.<sup>124</sup> However, a taxpayer will be treated as having adequately disclosed a transaction for this purpose if the IRS Commissioner has separately rescinded the separate penalty under section 6707A for failure to disclose a reportable transaction.<sup>125</sup> The IRS Commissioner is authorized to do this only if the failure does not relate to a listed transaction and only if rescinding the penalty would promote compliance and effective tax administration.<sup>126</sup>

A public entity that is required to pay a penalty for an undisclosed listed or reportable transaction must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear; and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).<sup>127</sup>

#### Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this provision, the amount of the understatement is determined as the sum of: (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return);<sup>128</sup> and (2) the amount of

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<sup>124</sup> Sec. 6662A(c).

<sup>125</sup> Sec. 6664(d).

<sup>126</sup> Sec. 6707A(d).

<sup>127</sup> Sec. 6707A(e).

<sup>128</sup> For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income. Sec. 6662A(b).

any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

Except as provided in regulations, a taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.<sup>129</sup>

#### Strengthened reasonable cause exception

A penalty is not imposed under the provision with respect to any portion of an understatement if it is shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires: (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011;<sup>130</sup> (2) that there is or was substantial authority for such treatment; and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief: (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed; and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.<sup>131</sup>

A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion (1) is provided by a "disqualified tax advisor" or (2) is a "disqualified opinion."

#### Disqualified tax advisor

A disqualified tax advisor is any advisor who: (1) is a material advisor<sup>132</sup> and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates; (2) is

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<sup>129</sup> Sec. 6662A(e)(3).

<sup>130</sup> See the previous discussion regarding the penalty for failing to disclose a reportable transaction.

<sup>131</sup> Sec. 6664(d).

<sup>132</sup> The term "material advisor" means any person who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of \$50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons (\$250,000 in any other case). Sec. 6111(b)(1).

compensated directly or indirectly<sup>133</sup> by a material advisor with respect to the transaction; (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained; or (4) as determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

A material advisor is considered as participating in the “organization” of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents: (1) establishing a structure used in connection with the transaction (such as a partnership agreement); (2) describing the transaction (such as an offering memorandum or other statement describing the transaction); or (3) relating to the registration of the transaction with any federal, state or local government body.<sup>134</sup> Participation in the “management” of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the “promotion or sale” of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

#### Disqualified opinion

An opinion may not be relied upon if the opinion: (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events); (2) unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person; (3) does not identify and consider all relevant facts; or (4) fails to meet any other requirement prescribed by the Secretary.

#### Coordination with other penalties

To the extent a penalty on an understatement is imposed under section 6662A, that same amount of understatement is not also subject to the accuracy-related penalty under section 6662(a) or to the valuation misstatement penalties under section 6662(e) or 6662(h). However, such amount of understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under

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<sup>133</sup> This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

<sup>134</sup> An advisor should not be treated as participating in the organization of a transaction if the advisor’s only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a “disqualified tax advisor” with respect to the transaction if the advisor participates in the management, promotion or sale of the transaction (or if the advisor is compensated by a material advisor, has a fee arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary, has a continuing financial interest with respect to the transaction).

section 6662(d)(1) and for purposes of identifying an underpayment under the section 6663 fraud penalty.

The penalty imposed under section 6662A does not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

### **Description of Proposal**

The proposal imposes a penalty for an understatement attributable to any transaction that lacks economic substance (referred to in the statute as a “non-economic substance transaction understatement”).<sup>135</sup> The penalty rate is 40 percent (reduced to 20 percent if the taxpayer adequately discloses the relevant facts in accordance with regulations prescribed under section 6011). No exceptions (including the reasonable cause or rescission rules) to the penalty are available (i.e., the penalty is a strict-liability penalty).

A “non-economic substance transaction” means any transaction if (1) the transaction lacks economic substance (as defined in the earlier proposal regarding the economic substance doctrine),<sup>136</sup> (2) the transaction was not respected under the rules relating to transactions with tax-indifferent parties (as described in the immediately preceding proposal regarding the economic substance doctrine),<sup>137</sup> or (3) any similar rule of law. For this purpose, a similar rule of law would include, for example, an understatement attributable to a transaction that is determined to be a sham transaction.

For purposes of the proposal, the calculation of an “understatement” is made in the same manner as in the present law provision relating to accuracy-related penalties for listed and reportable avoidance transactions (sec. 6662A). Thus, the amount of the understatement under the proposal would be determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer’s treatment of the item and the proper treatment of the item

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<sup>135</sup> Thus, unlike the present-law accuracy-related penalty under section 6662A (which applies only to listed and reportable avoidance transactions), the new penalty under the proposal applies to any transaction that lacks economic substance.

<sup>136</sup> The proposal generally provides that in any case in which a court determines that the economic substance doctrine is relevant, a transaction has economic substance only if: (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose. Specific other rules also apply. See “Description of Proposal” for the immediately preceding provision, “Clarification of the economic substance doctrine.”

<sup>137</sup> The proposal provides that the form of a transaction that involves a tax-indifferent party will not be respected in certain circumstances.

(without regard to other items on the tax return),<sup>138</sup> and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. In essence, the penalty will apply to the amount of any understatement attributable solely to a non-economic substance transaction.

As in the case of the understatement penalty for reportable and listed transactions under present law section 6662A(e)(3), except as provided in regulations, the taxpayer's treatment of an item will not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted regarding an examination of such return or such other date as specified by the Secretary.

As in the case of the understatement penalty for undisclosed reportable transactions under present law section 6707A, a public entity that is required to pay a penalty under the provision (but in this case, regardless of whether the transaction was disclosed) must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Regardless of whether the transaction was disclosed, once a penalty under the proposal has been included in the first letter of proposed deficiency which allows the taxpayer an opportunity for administrative review in the IRS Office of Appeals, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally. Furthermore, the IRS is required to keep records summarizing the application of this penalty and providing a description of each penalty compromised under the proposal and the reasons for the compromise.

Any understatement on which a penalty is imposed under the provision will not be subject to the accuracy-related penalty under section 6662 or under 6662A (accuracy-related penalties for listed and reportable avoidance transactions). However, an understatement under the Senate amendment is taken into account for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1). The penalty imposed under the proposal will not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

### **Effective Date**

The proposal applies to transactions entered into after the date of enactment.

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<sup>138</sup> For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses that would (without regard to section 1211) be allowed for such year, would be treated as an increase in taxable income.

### **3. Denial of deduction for interest on underpayments attributable to noneconomic substance transactions**

#### **Present Law**

No deduction for interest is allowed for interest paid or accrued on any underpayment of tax which is attributable to the portion of any reportable transaction understatement with respect to which the relevant facts were not adequately disclosed.<sup>139</sup> The Secretary of the Treasury is authorized to define reportable transactions for this purpose.<sup>140</sup>

#### **Description of Proposal**

The proposal extends the disallowance of interest deductions to interest paid or accrued on any underpayment of tax which is attributable to any noneconomic substance underpayment (whether or not disclosed).

#### **Effective Date**

The proposal applies to transactions after the date of enactment in taxable years ending after such date.

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<sup>139</sup> Sec. 162(m). Under section 6664(d)(2)(A), in such a case of nondisclosure, the taxpayer also is not entitled to the “reasonable cause and good faith” exception to the section 6662A penalty for a reportable transaction understatement.

<sup>140</sup> See the description of present law under the immediately preceding proposal, “Penalty for understatements attributable to transactions lacking economic substance, etc.”

## **C. Improvements in Efficiency and Safeguards in IRS Collection**

### **1. Waiver of user fee for installment agreements using automated withdrawals**

#### **Present Law**

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed.<sup>141</sup> An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

The IRS charges a user fee if a request for an installment agreement is approved.

#### **Description of Proposal**

The proposal waives the user fee for installment agreements in which the parties agree to the use of automated installment payments (such as automated debits from a bank account).

#### **Effective Date**

The proposal applies to agreements entered into on or after the date which is 180 days after the date of enactment.

### **2. Termination of installment agreements**

#### **Present Law**

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments, if the IRS determines that doing so will facilitate collection of the amounts owed.<sup>142</sup> An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

Under present law, the IRS is permitted to terminate an installment agreement only if: (1) the taxpayer fails to pay an installment at the time the payment is due; (2) the taxpayer fails to pay any other tax liability at the time when such liability is due; (3) the taxpayer fails to provide a financial condition update as required by the IRS; (4) the taxpayer provides inadequate

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<sup>141</sup> Sec. 6159.

<sup>142</sup> Sec. 6159.

or incomplete information when applying for an installment agreement; (5) there has been a significant change in the financial condition of the taxpayer; or (6) the collection of the tax is in jeopardy.<sup>143</sup>

### **Description of Proposal**

The proposal grants the IRS authority to terminate installment agreement when a taxpayer fails to timely make a required Federal tax deposit or fails to timely file a tax return (including extensions). Under the proposal, the IRS may terminate an installment agreement even if the taxpayer remained current with payments under the installment agreement.

### **Effective Date**

The proposal is effective for failures occurring on or after the date of enactment.

## **3. Partial payments required with submissions of offers-in-compromise**

### **Present Law**

The IRS has the authority to compromise any civil or criminal case arising under the internal revenue laws.<sup>144</sup> In general, taxpayers initiate this process by making an offer-in-compromise, which is an offer by the taxpayer to settle an outstanding tax liability for less than the total amount due. The IRS currently imposes a user fee of \$150 on most offers, payable upon submission of the offer to the IRS. Taxpayers may justify their offers on the basis of doubt as to collectibility or liability or on the basis of effective tax administration. In general, enforcement action is suspended during the period that the IRS evaluates an offer. In some instances, it may take the IRS 12 to 18 months to evaluate an offer.<sup>145</sup> Taxpayers are permitted (but not required) to make a deposit with their offer; if the offer is rejected, the deposit is generally returned to the taxpayer. There are two general categories<sup>146</sup> of offers-in-compromise, lump-sum offers and periodic payment offers. Taxpayers making lump-sum offers propose to make one lump-sum payment of a specified dollar amount in settlement of their outstanding liability. Taxpayers making periodic payment offers propose to make a series of payments over time (either short-term or long-term) in settlement of their outstanding liability.

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<sup>143</sup> Sec. 6159(b)(2), (3), and (4).

<sup>144</sup> Sec. 7122.

<sup>145</sup> *Olsen v. United States*, 326 F. Supp. 2d 184 (D. Mass. 2004).

<sup>146</sup> The IRS categorizes payment plans with more specificity, which is generally not significant for purposes of the proposal. See Form 656, Offer in Compromise, page 6 of instruction booklet (revised July 2004).

### **Description of Proposal**

The proposal requires a taxpayer to make partial payments to the IRS while the taxpayer's offer is being considered by the IRS. For lump-sum offers, taxpayers must make a down payment of 20 percent of the amount of the offer with any application. For purposes of this proposal, a lump-sum offer includes single payments as well as payments made in five or fewer installments. For periodic payment offers, the proposal requires the taxpayer to comply with the taxpayer's own proposed payment schedule while the offer is being considered. Offers submitted to the IRS that do not comport with these payment requirements are returned to the taxpayer as unprocessable and immediate enforcement action is permitted. The proposal eliminates the user fee requirement for offers submitted with the appropriate partial payment.

The proposal also provides that an offer is deemed accepted if the IRS does not make a decision with respect to the offer within two years from the date the offer was submitted. With respect to offers submitted more than five years after the date of enactment, an offer is deemed accepted if the IRS does not make a decision with respect to the offer within 12 months of its submission.

### **Effective Date**

The proposal applies to offers-in-compromise submitted or pending on and after the date which is 60 days after the date of enactment.

## **D. Penalties and Fines**

### **1. Increase in criminal monetary penalty limitation for the underpayment or overpayment of tax due to fraud**

#### **Present Law**

##### **Attempt to evade or defeat tax**

In general, section 7201 imposes a criminal penalty on persons who willfully attempt to evade or defeat any tax imposed by the Code. Upon conviction, the Code provides that the penalty is up to \$100,000 or imprisonment of not more than five years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of \$500,000.

##### **Willful failure to file return, supply information, or pay tax**

In general, section 7203 imposes a criminal penalty on persons required to make estimated tax payments, pay taxes, keep records, or supply information under the Code who willfully fails to do so. Upon conviction, the Code provides that the penalty is up to \$25,000 or imprisonment of not more than one year (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of \$100,000.

##### **Fraud and false statements**

In general, section 7206 imposes a criminal penalty on persons who make fraudulent or false statements under the Code. Upon conviction, the Code provides that the penalty is up to \$100,000 or imprisonment of not more than three years (or both). In the case of a corporation, the Code increases the monetary penalty to a maximum of \$500,000.

##### **Uniform sentencing guidelines**

Under the uniform sentencing guidelines established by 18 U.S.C. 3571, a defendant found guilty of a criminal offense is subject to a maximum fine that is the greatest of: (a) the amount specified in the underlying provision, (b) for a felony<sup>147</sup> \$250,000 for an individual or \$500,000 for an organization, or (c) twice the gross gain if a person derives pecuniary gain from the offense. This Title 18 provision applies to all criminal provisions in the United States Code, including those in the Internal Revenue Code. For example, for an individual, the maximum fine under present law upon conviction of violating section 7206 is \$250,000 or, if greater, twice the amount of gross gain from the offense.

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<sup>147</sup> Section 7206 states that making fraudulent or false statements under the Code is a felony. In addition, this offense is a felony pursuant to the classification guidelines of 18 U.S.C. 3559(a)(5).

## **Description of Proposal**

### **Attempt to evade or defeat tax**

The proposal increases the criminal penalty under section 7201 of the Code for individuals to \$500,000 and for corporations to \$1,000,000. The proposal increases the maximum prison sentence to ten years.

### **Willful failure to file return, supply information, or pay tax**

The proposal increases the criminal penalty under section 7203 of the Code for individuals from \$25,000 to \$50,000 and, in the case of an “aggravated failure to file” (defined as a failure to file a return for a period of three or more consecutive taxable years if the aggregated tax liability for such period is at least \$100,000), changes the crime from a misdemeanor to a felony and increases the maximum prison sentence to ten years.

### **Fraud and false statements**

The proposal increases the criminal penalty for making fraudulent or false statements to \$500,000 for individuals and \$1,000,000 for corporations. The proposal increases the maximum prison sentence for making fraudulent or false statements to five years. The proposal provides that in no event shall the amount of the monetary penalty under this proposal be less than the amount of the underpayment or overpayment attributable to fraud.

## **Effective Date**

The proposal applies to actions and failures to act occurring after the date of enactment.

## **2. Doubling of certain penalties, fines, and interest on underpayments related to certain offshore financial arrangements**

### **Present Law**

#### **In general**

The Code contains numerous civil penalties, such as the delinquency, accuracy-related, fraud, and assessable penalties. These civil penalties are in addition to any interest that may be due as a result of an underpayment of tax. If all or any part of a tax is not paid when due, the Code imposes interest on the underpayment, which is assessed and collected in the same manner as the underlying tax and is subject to the respective statutes of limitations for assessment and collection.

#### **Delinquency penalties**

**Failure to file.**—Under present law, a taxpayer who fails to file a tax return on a timely basis is generally subject to a penalty equal to 5 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent. An exception from the penalty applies if the failure is due to reasonable cause. In the case of fraudulent failure

to file, the penalty is increased to 15 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 75 percent. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.

Failure to pay.—Taxpayers who fail to pay their taxes are subject to a penalty of 0.5 percent per month on the unpaid amount, up to a maximum of 25 percent. If a penalty for failure to file and a penalty for failure to pay tax shown on a return both apply for the same month, the amount of the penalty for failure to file for such month is reduced by the amount of the penalty for failure to pay tax shown on a return. If an income tax return is filed more than 60 days after its due date, then the penalty for failure to pay tax shown on a return may not reduce the penalty for failure to file below the lesser of \$100 or 100 percent of the amount required to be shown on the return. For any month in which an installment payment agreement with the IRS is in effect, the rate of the penalty is half the usual rate (0.25 percent instead of 0.5 percent), provided that the taxpayer filed the tax return in a timely manner (including extensions).

Failure to make timely deposits of tax.—The penalty for the failure to make timely deposits of tax consists of a four-tiered structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure. A depositor is subject to a penalty equal to 2 percent of the amount of the underpayment if the failure is corrected on or before the date that is five days after the prescribed due date. A depositor is subject to a penalty equal to 5 percent of the amount of the underpayment if the failure is corrected after the date that is five days after the prescribed due date but on or before the date that is 15 days after the prescribed due date. A depositor is subject to a penalty equal to 10 percent of the amount of the underpayment if the failure is corrected after the date that is 15 days after the due date but on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). Finally, a depositor is subject to a penalty equal to 15 percent of the amount of the underpayment if the failure is not corrected on or before earlier of 10 days after the date of the first delinquency notice to the taxpayer and 10 days after the date on which notice and demand for immediate payment of tax is given in cases of jeopardy.

An exception from the penalty applies if the failure is due to reasonable cause. In addition, the Secretary may waive the penalty for an inadvertent failure to deposit any tax by specified first-time depositors.

### **Accuracy-related penalties**

In general.—The accuracy-related penalties are imposed at a rate of 20 percent of the portion of any underpayment that is attributable, in relevant part, to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, and (4) any reportable transaction understatement. The penalty for a substantial valuation misstatement is doubled for certain gross valuation misstatements. In the case of a reportable transaction understatement for which the transaction is not disclosed, the penalty rate is 30 percent. These penalties are coordinated with the fraud penalty. This statutory structure operates to eliminate any stacking of the penalties.

No penalty is to be imposed if it is shown that there was reasonable cause for an underpayment and the taxpayer acted in good faith, and in the case of a reportable transaction understatement the relevant facts of the transaction have been disclosed, there is or was substantial authority for the taxpayer's treatment of such transaction, and the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

Negligence or disregard for the rules or regulations.—If an underpayment of tax is attributable to negligence, the negligence penalty applies only to the portion of the underpayment that is attributable to negligence. Negligence means any failure to make a reasonable attempt to comply with the provisions of the Code. Disregard includes any careless, reckless, or intentional disregard of the rules or regulations.

Substantial understatement of income tax.—Generally, an understatement is substantial if the understatement exceeds the greater of (1) 10 percent of the tax required to be shown on the return for the tax year, or (2) \$5,000. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return.

Substantial valuation misstatement.—A penalty applies to the portion of an underpayment that is attributable to a substantial valuation misstatement. Generally, a substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the correct value or adjusted basis. The amount of the penalty for a substantial valuation misstatement is 20 percent of the amount of the underpayment if the value or adjusted basis claimed is 200 percent or more but less than 400 percent of the correct value or adjusted basis. If the value or adjusted basis claimed is 400 percent or more of the correct value or adjusted basis, then the overvaluation is a gross valuation misstatement.

Reportable transaction understatement.—A penalty applies to any item that is attributable to any listed transaction, or to any reportable transaction (other than a listed transaction) if a significant purpose of such reportable transaction is tax avoidance or evasion.

### **Fraud penalty**

The fraud penalty is imposed at a rate of 75 percent of the portion of any underpayment that is attributable to fraud. The accuracy-related penalty does not apply to any portion of an underpayment on which the fraud penalty is imposed.

### **Assessable penalties**

In addition to the penalties described above, the Code imposes a number of additional penalties, including, for example, penalties for failure to file (or untimely filing of) information returns with respect to foreign trusts, and penalties for failure to disclose any required information with respect to a reportable transaction.

## **Interest provisions**

Taxpayers are required to pay interest to the IRS whenever there is an underpayment of tax. An underpayment of tax exists whenever the correct amount of tax is not paid by the last date prescribed for the payment of the tax. The last date prescribed for the payment of the income tax is the original due date of the return.

Different interest rates are provided for the payment of interest depending upon the type of taxpayer, whether the interest relates to an underpayment or overpayment, and the size of the underpayment or overpayment. Interest on underpayments is compounded daily.

## **Offshore Voluntary Compliance Initiative**

In January 2003, Treasury announced the Offshore Voluntary Compliance Initiative (“OVCI”) to encourage the voluntary disclosure of previously unreported income placed by taxpayers in offshore accounts and accessed through credit card or other financial arrangements. A taxpayer had to comply with various requirements in order to participate in the OVCI, including sending a written request to participate in the program by April 15, 2003. This request had to include information about the taxpayer, the taxpayer’s introduction to the credit card or other financial arrangements and the names of parties that promoted the transaction. Taxpayers entering into a closing agreement under the OVCI will not be liable for civil fraud, the fraudulent failure to file penalty, or the civil information return penalties. The taxpayer will pay back taxes, interest, and certain accuracy-related and delinquency penalties.<sup>148</sup>

## **Voluntary disclosure policy**

A taxpayer's timely, voluntary disclosure of a substantial unreported tax liability has long been an important factor in deciding whether the taxpayer's case should ultimately be referred for criminal prosecution. The voluntary disclosure must be truthful, timely, and complete. The taxpayer must show a willingness to cooperate (as well as actual cooperation) with the IRS in determining the correct tax liability. The taxpayer must make good-faith arrangements with the IRS to pay in full the tax, interest, and any penalties determined by the IRS to be applicable. A voluntary disclosure does not guarantee immunity from prosecution. It creates no substantive or procedural rights for taxpayers.<sup>149</sup>

### **Description of Proposal**

The proposal doubles the amounts of civil penalties, interest, and fines related to taxpayers’ underpayments of U.S. income tax liability through the use of certain offshore financial arrangements. The proposal applies to taxpayers who did not voluntarily disclose such arrangements through the OVCI or otherwise. Under the proposal, the determination of whether any civil penalty is to be applied to such underpayment is made without regard to whether a

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<sup>148</sup> Rev. Proc. 2003-11, 2003-4 C.B. 311.

<sup>149</sup> Internal Revenue News Release 2002-135, IR-2002-135 (December 11, 2002).

return has been filed, whether there was reasonable cause for such underpayment, and whether the taxpayer acted in good faith.

The Secretary of the Treasury is granted the authority to waive the application of the proposal if the use of the offshore financial arrangements is incidental to the transaction and, in the case of a trade or business, such use is conducted in the ordinary course of the type of trade or business in which the taxpayer is engaged. The IRS may retain and use up to 25 percent of the amounts collected under the proposal for enforcement and collection purposes.

The Secretary of the Treasury is required to conduct a study and report to Congress annually on the implementation of the proposal, including statistics on the number of taxpayers affected and the amounts of penalties and interest asserted, waived, and assessed.

### **Effective Date**

The proposal generally is effective with respect to a taxpayer's open tax years on or after date of enactment.

## **3. Denial of deduction for certain fines, penalties, and other amounts**

### **Present Law**

Under present law, no deduction is allowed as a trade or business expense under section 162(a) for the payment of a fine or similar penalty to a government for the violation of any law (sec. 162(f)). The enactment of section 162(f) in 1969 codified existing case law that denied the deductibility of fines as ordinary and necessary business expenses on the grounds that "allowance of the deduction would frustrate sharply defined national or State policies proscribing the particular types of conduct evidenced by some governmental declaration thereof."<sup>150</sup>

Treasury regulation section 1.162-21(b)(1) provides that a fine or similar penalty includes an amount: (1) paid pursuant to conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding; (2) paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Code; (3) paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or (4) forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty. Treasury regulation section 1.162-21(b)(2) provides, among other things, that compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.

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<sup>150</sup> S. Rep. 91-552, 91<sup>st</sup> Cong, 1<sup>st</sup> Sess., 273-74 (1969), referring to *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 30 (1958).

## **Description of Proposal**

The proposal modifies the rules regarding the determination whether payments are nondeductible payments of fines or penalties under section 162(f). In particular, the proposal generally provides that amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government in relation to the violation of any law or the investigation or inquiry into the potential violation of any law<sup>151</sup> are nondeductible under any provision of the income tax provisions.<sup>152</sup> The proposal applies to deny a deduction for any such payments, including those where there is no admission of guilt or liability and those made for the purpose of avoiding further investigation or litigation. An exception applies to payments that the taxpayer establishes are either restitution (including remediation of property), or amounts required to come into compliance with any law that was violated or involved in the investigation or inquiry, and that are identified in the court order or settlement as restitution, remediation, or required to come into compliance.<sup>153</sup> The IRS remains free to challenge the characterization of an amount so identified; however, no deduction is allowed unless the identification is made.<sup>154</sup>

An exception also applies to any amount paid or incurred as taxes due.

The proposal is intended to apply only where a government (or other entity treated in a manner similar to a government under the amendment) is a complainant or investigator with respect to the violation or potential violation of any law.<sup>155</sup>

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<sup>151</sup> The proposal does not affect amounts paid or incurred in performing routine audits or reviews such as annual audits that are required of all organizations or individuals in a similar business sector, or profession, as a requirement for being allowed to conduct business. However, if the government or regulator raised an issue of compliance and a payment is required in settlement of such issue, the proposal would affect that payment.

<sup>152</sup> The proposal provides that such amounts are nondeductible under chapter 1 of the Internal Revenue Code.

<sup>153</sup> The proposal does not affect the treatment of antitrust payments made under section 4 of the Clayton Act, which will continue to be governed by the provisions of section 162(g).

<sup>154</sup> If a settlement agreement does not specify a specific amount to be paid for the purpose of coming into compliance but instead simply requires the taxpayer to come into compliance, it is sufficient identification to so state. Amounts expended by the taxpayer for that purpose would then be considered identified. However, if an agreement specifies a specific dollar amount that must be paid or incurred, the amount would not be eligible to be deducted without a specification that it is for restitution (including remediation of property), or coming into compliance.

<sup>155</sup> Thus, for example, the proposal would not apply to payments made by one private party to another in a lawsuit between private parties, merely because a judge or jury acting in the capacity as a court directs the payment to be made. The mere fact that a court enters a judgment or directs a result in a private dispute does not cause a payment to be made “at the direction of a government” for purposes of the provision.

It is intended that a payment will be treated as restitution (including remediation of property) only if substantially all of the payment is required to be paid to the specific persons, or in relation to the specific property, actually harmed by the conduct of the taxpayer that resulted in the payment. Thus, a payment to or with respect to a class substantially broader than the specific persons or property that were actually harmed (e.g., to a class including similarly situated persons or property) does not qualify as restitution or included remediation of property.<sup>156</sup> Restitution and included remediation of property is limited to the amount that bears a substantial quantitative relationship to the harm caused by the past conduct or actions of the taxpayer that resulted in the payment in question. If the party harmed is a government or other entity, then restitution and included remediation of property includes payment to such harmed government or entity, provided the payment bears a substantial quantitative relationship to the harm. However, restitution or included remediation of property does not include reimbursement of government investigative or litigation costs, or payments to whistleblowers.

It is intended that a payment will be treated as an amount required to come into compliance only if it directly corrects a violation with respect to a particular requirement of law that was under investigation. For example, if the law requires a particular emission standard to be met or particular machinery to be used, amounts required to be paid under a settlement agreement to meet the required standard or install the machinery are deductible to the extent otherwise allowed. Similarly, if the law requires certain practices and procedures to be followed and a settlement agreement requires the taxpayer to pay to establish such practices or procedures, such amounts would be deductible. However, amounts paid for other purposes not directly correcting a violation of law are not deductible. For example, amounts paid to bring other machinery that is already in compliance up to a standard higher than required by the law, or to create other benefits (such as a park or other action not previously required by law), are not deductible if required under a settlement agreement. Similarly, amounts paid to educate consumers or customers about the risks of doing business with the taxpayer or about the field in which the taxpayer does business generally, which education efforts are not specifically required under the law, are not deductible if required under a settlement agreement.

The proposal requires government agencies to report to the IRS and to the taxpayer the amount of each settlement agreement or order entered where the aggregate amount required to be paid or incurred to or at the direction of the government under such settlement agreements and orders with respect to the violation, investigation, or inquiry is least \$600 (or such other amount as may be specified by the Secretary of the Treasury as necessary to ensure the efficient administration of the Internal Revenue laws). The reports must be made within 30 days of entering the settlement agreement, or such other time as may be required by Secretary. The

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<sup>156</sup> Similarly, a payment to a charitable organization benefiting a broader class than the persons or property actually harmed, or to be paid out without a substantial quantitative relationship to the harm caused, would not qualify as restitution. Under the proposal, such a payment not deductible under section 162 would also not be deductible under section 170.

report must separately identify any amounts that are restitution or remediation of property, or correction of noncompliance.<sup>157</sup>

The IRS is encouraged in addition to require taxpayers to identify separately on their tax returns the amounts of any such settlements with respect to which reporting is required under the proposal, including separate identification of the nondeductible amount and of any amount deductible as restitution, remediation, or required to correct noncompliance.<sup>158</sup>

Amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, any self-regulatory entity that regulates a financial market or other market that is a qualified board or exchange under section 1256(g)(7), and that is authorized to impose sanctions (e.g., the National Association of Securities Dealers) are likewise subject to the provision if paid in relation to a violation, or investigation or inquiry into a potential violation, of any law (or any rule or other requirement of such entity). To the extent provided in regulations, amounts paid or incurred to, or at the direction of, any other nongovernmental entity that exercises self-regulatory powers as part of performing an essential governmental function are similarly subject to the provision. The exception for payments that the taxpayer establishes are paid or incurred for restitution, remediation of property, or coming into compliance and that are identified as such in the order or settlement agreement likewise applies in these cases. The requirement of reporting to the IRS and the taxpayer also applies in these cases.

No inference is intended as to the treatment of payments as nondeductible fines or penalties under present law. In particular, the proposal is not intended to limit the scope of present-law section 162(f) or the regulations thereunder.

### **Effective Date**

The proposal is effective for amounts paid or incurred on or after the date of enactment; however the proposal does not apply to amounts paid or incurred under any binding order or agreement entered into before such date. Any order or agreement requiring court approval is not a binding order or agreement for this purpose unless such approval was obtained before the date of enactment.

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<sup>157</sup> As in the case of the identification requirement, if the agreement does not specify a specific amount to be expended to come into compliance but simply requires that to occur, it is expected that the report may state simply that the taxpayer is required to come into compliance but no specific dollar amount has been specified for that purpose in the settlement agreement.

<sup>158</sup> For example, the IRS might require such reporting as part of the schedule M-3, whether or not the particular amounts create a book-tax difference.

#### **4. Denial of deduction for punitive damages**

##### **Present Law**

In general, a deduction is allowed for all ordinary and necessary expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business.<sup>159</sup> However, no deduction is allowed for any payment that is made to an official of any governmental agency if the payment constitutes an illegal bribe or kickback or if the payment is to an official or employee of a foreign government and is illegal under Federal law.<sup>160</sup> In addition, no deduction is allowed under present law for any fine or similar payment made to a government for violation of any law.<sup>161</sup> Furthermore, no deduction is permitted for two-thirds of any damage payments made by a taxpayer who is convicted of a violation of the Clayton antitrust law or any related antitrust law.<sup>162</sup>

In general, gross income does not include amounts received on account of personal physical injuries and physical sickness.<sup>163</sup> However, this exclusion does not apply to punitive damages.<sup>164</sup>

##### **Description of Proposal**

The proposal denies any deduction for punitive damages that are paid or incurred by the taxpayer as a result of a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, any such punitive damages paid by the insurer are included in gross income of the insured person and the insurer is required to report such amounts to both the insured person and the IRS.

##### **Effective Date**

The proposal is effective for punitive damages that are paid or incurred on or after the date of enactment.

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<sup>159</sup> Sec. 162(a).

<sup>160</sup> Sec. 162(c).

<sup>161</sup> Sec. 162(f).

<sup>162</sup> Sec. 162(g).

<sup>163</sup> Sec. 104(a).

<sup>164</sup> Sec. 104(a)(2).

## **5. Increase in penalty for bad checks and money orders**

### **Present Law**

The Code<sup>165</sup> imposes a penalty for bad checks and money orders on the person who tendered it. The penalty is two percent of the amount of the bad check or money order. For checks that are less than \$750, the minimum penalty is \$15 (or, if less, the amount of the check).

### **Description of Proposal**

The proposal increases the minimum penalty to \$25 (or, if less, the amount of the check), applicable to checks that are less than \$1,250.

### **Effective Date**

The proposal applies to checks or money orders received after the date of enactment.

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<sup>165</sup> Sec. 6657.

## **E. Provisions to Discourage Expatriation**

### **1. Tax treatment of inverted entities**

#### **Present Law**

##### **Determination of corporate residence**

The U.S. tax treatment of a multinational corporate group depends significantly on whether the parent corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the law of the United States or of any State. Other corporations (i.e., those incorporated under the laws of foreign countries) generally are treated as foreign.

##### **U.S. taxation of domestic corporations**

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

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, and U.S. tax is imposed on such income when repatriated. However, certain anti-deferral regimes may cause the domestic parent corporation to be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral regimes in this context are the controlled foreign corporation rules of subpart F (secs. 951-964) and the passive foreign investment company rules (secs. 1291-1298). A foreign tax credit is generally available to offset, in whole or in part, the U.S. tax owed on this foreign-source income, whether repatriated as an actual dividend or included under one of the anti-deferral regimes.

##### **U.S. taxation of foreign corporations**

The United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income that is “effectively connected” with the conduct of a trade or business in the United States. Such “effectively connected income” generally is taxed in the same manner and at the same rates as the income of a U.S. corporation. An applicable tax treaty may limit the imposition of U.S. tax on business operations of a foreign corporation to cases in which the business is conducted through a “permanent establishment” in the United States.

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected

by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable tax treaty.

### **U.S. tax treatment of inversion transactions prior to the American Jobs Creation Act of 2004**

Prior to the American Jobs Creation Act of 2004 (“AJCA”), a U.S. corporation could reincorporate in a foreign jurisdiction and thereby replace the U.S. parent corporation of a multinational corporate group with a foreign parent corporation. These transactions were commonly referred to as inversion transactions. Inversion transactions could take many different forms, including stock inversions, asset inversions, and various combinations of and variations on the two. Most of the known transactions were stock inversions. In one example of a stock inversion, a U.S. corporation forms a foreign corporation, which in turn forms a domestic merger subsidiary. The domestic merger subsidiary then merges into the U.S. corporation, with the U.S. corporation surviving, now as a subsidiary of the new foreign corporation. The U.S. corporation’s shareholders receive shares of the foreign corporation and are treated as having exchanged their U.S. corporation shares for the foreign corporation shares. An asset inversion could be used to reach a similar result, but through a direct merger of the top-tier U.S. corporation into a new foreign corporation, among other possible forms. An inversion transaction could be accompanied or followed by further restructuring of the corporate group. For example, in the case of a stock inversion, in order to remove income from foreign operations from the U.S. taxing jurisdiction, the U.S. corporation could transfer some or all of its foreign subsidiaries directly to the new foreign parent corporation or other related foreign corporations.

In addition to removing foreign operations from U.S. taxing jurisdiction, the corporate group could seek to derive further advantage from the inverted structure by reducing U.S. tax on U.S.-source income through various earnings stripping or other transactions. This could include earnings stripping through payment by a U.S. corporation of deductible amounts such as interest, royalties, rents, or management service fees to the new foreign parent or other foreign affiliates. In this respect, the post-inversion structure could enable the group to employ the same tax-reduction strategies that are available to other multinational corporate groups with foreign parents and U.S. subsidiaries, subject to the same limitations (e.g., secs. 163(j) and 482).

Inversion transactions could give rise to immediate U.S. tax consequences at the shareholder and/or the corporate level, depending on the type of inversion. In stock inversions, the U.S. shareholders generally recognized gain (but not loss) under section 367(a), based on the difference between the fair market value of the foreign corporation shares received and the adjusted basis of the domestic corporation stock exchanged. To the extent that a corporation’s share value had declined, and/or it had many foreign or tax-exempt shareholders, the impact of this section 367(a) “toll charge” was reduced. The transfer of foreign subsidiaries or other assets to the foreign parent corporation also could give rise to U.S. tax consequences at the corporate level (e.g., gain recognition and earnings and profits inclusions under secs. 1001, 311(b), 304, 367, 1248 or other provisions). The tax on any income recognized as a result of these restructurings could be reduced or eliminated through the use of net operating losses, foreign tax credits, and other tax attributes.

In asset inversions, the U.S. corporation generally recognized gain (but not loss) under section 367(a) as though it had sold all of its assets, but the shareholders generally did not recognize gain or loss, assuming the transaction met the requirements of a reorganization under section 368.

## **U.S. tax treatment of inversion transactions under AJCA**

### In general

AJCA added new section 7874 to the Code, which defines two different types of corporate inversion transactions and establishes a different set of consequences for each type. Certain partnership transactions also are covered.

### Transactions involving at least 80 percent identity of stock ownership

The first type of inversion is a transaction in which, pursuant to a plan<sup>166</sup> or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the “expanded affiliated group”), does not have substantial business activities in the entity’s country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The provision denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.<sup>167</sup>

In determining whether a transaction meets the definition of an inversion under the provision, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called “hook” stock), the stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded, with the result that the transaction would not meet the definition of an inversion under the provision. Stock sold in a public offering related to the transaction also is disregarded for these purposes.

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<sup>166</sup> Acquisitions with respect to a domestic corporation or partnership are deemed to be “pursuant to a plan” if they occur within the four-year period beginning on the date which is two years before the ownership threshold under the provision is met with respect to such corporation or partnership.

<sup>167</sup> Since the top-tier foreign corporation is treated for all purposes of the Code as domestic, the shareholder-level “toll charge” of sec. 367(a) does not apply to these inversion transactions.

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the proposal are disregarded. In addition, the Treasury Secretary is to provide regulations to carry out the proposal, including regulations to prevent the avoidance of the purposes of the proposal, including avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person or a member of an expanded affiliated group. Similarly, the Treasury Secretary has the authority to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the proposal.

#### Transactions involving at least 60 percent but less than 80 percent identity of stock ownership

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if at least a 60-percent ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but any applicable corporate-level “toll charges” for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits. Specifically, any applicable corporate-level income or gain required to be recognized under sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation as part of the inversion transaction or after such transaction to a related foreign person is taxable, without offset by any tax attributes (e.g., net operating losses or foreign tax credits). This rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a 10-year period following the inversion transaction.

#### Other rules

Under section 7874, inversion transactions include certain partnership transactions. Specifically, the provision applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60 percent (or 80 percent, as the case may be) of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met. For purposes of applying this test, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified “toll charge” proposals apply at the partner level.

A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before March 4, 2003, the foreign-incorporated entity had acquired directly or indirectly more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business, as the case may be.

## **Description of Proposal**

The proposal makes several changes to the inversions regime of section 7874. First, the proposal applies the provisions of section 7874 to transactions completed after March 20, 2002 (as opposed to March 4, 2003 under present law). A transaction otherwise meeting the definition of an inversion transaction under the proposal is not treated as an inversion transaction if, on or before March 20, 2002, the foreign-incorporated entity had acquired directly or indirectly more than half the properties held directly or indirectly by the domestic corporation, or more than half the properties constituting the partnership trade or business, as the case may be.

The proposal also lowers the present-law 60-percent ownership threshold for the second category of inversion transactions to greater-than-50-percent, and increases the accuracy-related penalties and tightens the earnings stripping rules of section 163(j) with respect to companies involved in this type of transaction. Specifically, the 20-percent penalty for negligence or disregard of rules or regulations, substantial understatement of income tax, and substantial valuation misstatement is increased to 30 percent with respect to taxpayers related to the inverted entity, and the 40-percent penalty for gross valuation misstatement is increased to 50 percent with respect to such taxpayers. In applying section 163(j) to taxpayers related to the inverted entity, the generally applicable debt-equity threshold is eliminated, and the 50-percent thresholds for “excess interest expense” and “excess limitation” are lowered to 25 percent.

The proposal excludes from the inversions regime the acquisition of a U.S. corporation in cases in which none of the stock of the U.S. corporation was readily tradable on an established securities market at any time during the four-year period ending on the date of the acquisition, except as provided in regulations.

## **Effective Date**

The proposal is effective for taxable years ending after March 20, 2002.

## **2. Revision of tax rules on expatriation of individuals**

### **Present Law**

#### **In general**

U.S. citizens and residents generally are subject to U.S. income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. trade or business. The estates of nonresident aliens generally are subject to estate tax on U.S.-situated property (e.g., real estate and tangible property located within the United States and stock in a U.S. corporation). Nonresident aliens generally are subject to gift tax on transfers by gift of U.S.-situated property (e.g., real estate and tangible property located within the United States), but excluding intangibles, such as stock, regardless of where they are located.

## **Income tax rules with respect to expatriates**

For the 10 taxable years after an individual relinquishes his or her U.S. citizenship or terminates his or her U.S. long-term residency, unless certain conditions are met, the individual is subject to an alternative method of income taxation than that generally applicable to nonresident aliens (the “alternative tax regime”). Generally, the individual is subject to income tax only on U.S.-source income<sup>168</sup> at the rates applicable to U.S. citizens for the 10-year period.

A “long-term resident” is a noncitizen who is a lawful permanent resident of the United States in at least eight taxable years during the period of 15 taxable years ending with the taxable year during which the individual either ceases to be a lawful permanent resident of the United States or commences to be treated as a resident of a foreign country under a tax treaty between such foreign country and the United States (and does not waive such benefits).

A former citizen or former long-term resident is subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed \$124,000 (adjusted for inflation after 2004) and his or her net worth does not exceed \$2 million, or alternatively satisfies limited, objective exceptions for certain dual citizens and minors who have had no substantial contacts with the United States; and (2) certifies under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years and provides such evidence of compliance as the Secretary of the Treasury may require.

A former citizen who exceeds the monetary thresholds is excluded from the alternative tax regime if he or she falls within the exceptions for certain dual citizens and minors (provided that the requirement of certification and proof of compliance with Federal tax obligations is met). These exceptions provide relief to individuals who have never had substantial connections with the United States, as measured by certain objective criteria.

Anti-abuse rules are provided to prevent the circumvention of the alternative tax regime.

## **Estate tax rules with respect to expatriates**

Special estate tax rules apply to individuals who die during a taxable year in which he or she is subject to the alternative tax regime. Under these special rules, certain closely-held foreign stock owned by the former citizen or former long-term resident is includible in his or her gross estate to the extent that the foreign corporation owns U.S.-situated assets. The special rules apply if, at the time of death: (1) the former citizen or former long-term resident directly or indirectly owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation; and (2) directly or indirectly, is considered to own more than 50 percent of (a) the total combined voting power of all classes of stock entitled to vote in the foreign corporation, or (b) the total value of the stock of such corporation. If this

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<sup>168</sup> For this purpose, however, U.S.-source income has a broader scope than it does typically in the Code.

stock ownership test is met, then the gross estate of the former citizen or former long-term resident includes that proportion of the fair market value of the foreign stock owned by the individual at the time of death, which the fair market value of any assets owned by such foreign corporation and situated in the United States (at the time of death) bears to the total fair market value of all assets owned by such foreign corporation (at the time of death).

### **Gift tax rules with respect to expatriates**

Special gift tax rules apply to individuals who make gifts during a taxable year in which he or she is subject to the alternative tax regime. The individual is subject to gift tax on gifts of U.S.-situated intangibles made during the 10 years following citizenship relinquishment or residency termination. In addition, gifts of stock of certain closely-held foreign corporations by a former citizen or former long-term resident are subject to gift tax, if the gift is made during the time that such person is subject to the alternative tax regime. The operative rules with respect to these gifts of closely-held foreign stock are the same as described above relating to the estate tax, except that the relevant testing and valuation date is the date of gift rather than the date of death.

### **Termination of U.S. citizenship or long-term resident status for U.S. Federal income tax purposes**

An individual continues to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes, including for purposes of section 7701(b)(10), until the individual: (1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Secretary of State or the Secretary of Homeland Security, respectively; and (2) provides a statement to the Secretary of the Treasury in accordance with section 6039G.

### **Sanction for individuals subject to the individual tax regime who return to the United States for extended periods**

The alternative tax regime does not apply to any individual for any taxable year during the 10-year period following citizenship relinquishment or residency termination if such individual is present in the United States for more than 30 days in the calendar year ending in such taxable year. Such individual is treated as a U.S. citizen or resident for such taxable year and therefore is taxed on his or her worldwide income.

Similarly, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any calendar year ending during the 10-year period following citizenship relinquishment or residency termination, and the individual dies during that year, he or she is treated as a U.S. resident, and the individual's worldwide estate is subject to U.S. estate tax. Likewise, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any year during the 10-year period following citizenship relinquishment or residency termination, the individual is subject to U.S. gift tax on any transfer of his or her worldwide assets by gift during that taxable year.

For purposes of these rules, an individual is treated as present in the United States on any day if such individual is physically present in the United States at any time during that day. The present-law exceptions from being treated as present in the United States for residency

purposes<sup>169</sup> generally do not apply for this purpose. However, for individuals with certain ties to countries other than the United States<sup>170</sup> and individuals with minimal prior physical presence in the United States,<sup>171</sup> a day of physical presence in the United States is disregarded if the individual is performing services in the United States on such day for an unrelated employer (within the meaning of sections 267 and 707(b)), who meets the requirements the Secretary of the Treasury may prescribe in regulations. No more than 30 days may be disregarded during any calendar year under this rule.

### **Annual return**

Former citizens and former long-term residents are required to file an annual return for each year following citizenship relinquishment or residency termination in which they are subject to the alternative tax regime. The annual return is required even if no U.S. Federal income tax is due. The annual return requires certain information, including information on the permanent home of the individual, the individual's country of residence, the number of days the individual was present in the United States for the year, and detailed information about the individual's income and assets that are subject to the alternative tax regime. This requirement includes information relating to foreign stock potentially subject to the special estate and gift tax rules.

If the individual fails to file the statement in a timely manner or fails correctly to include all the required information, the individual is required to pay a penalty of \$10,000. The \$10,000 penalty does not apply if it is shown that the failure is due to reasonable cause and not to willful neglect.

## **Description of Proposal**

### **In general**

The proposal creates new section 877A, that generally subjects certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who terminate their U.S. residence to tax on the net unrealized gain in their property as if such property were sold for fair market value on the day before the expatriation or residency termination. Gain from the deemed

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<sup>169</sup> Secs. 7701(b)(3)(D), 7701(b)(5) and 7701(b)(7)(B)-(D).

<sup>170</sup> An individual has such a relationship to a foreign country if (1) the individual becomes a citizen or resident of the country in which the individual was born, such individual's spouse was born, or either of the individual's parents was born, and (2) the individual becomes fully liable for income tax in such country.

<sup>171</sup> An individual has a minimal prior physical presence in the United States if the individual was physically present for no more than 30 days during each year in the ten-year period ending on the date of loss of United States citizenship or termination of residency. However, an individual is not treated as being present in the United States on a day if the individual remained in the United States because of a medical condition that arose while the individual was in the United States. Sec. 7701(b)(3)(D)(ii).

sale is taken into account at that time without regard to other Code provisions; any loss from the deemed sale generally is taken into account to the extent otherwise provided in the Code. Any net gain on the deemed sale is recognized to the extent it exceeds \$600,000 (\$1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency). The \$600,000 amount is increased by a cost of living adjustment factor for calendar years after 2005.

### **Individuals covered**

Under the proposal, the mark-to-market tax applies to U.S. citizens who relinquish citizenship and long-term residents who terminate U.S. residency (collectively, “covered expatriates”). The definition of long-term resident under the proposal is the same as that under present law. As under present law, an individual is considered to terminate long-term residency when either the individual ceases to be a lawful permanent resident (i.e., loses his or her green card status), or the individual is treated as a resident of another country under a tax treaty and the individual does not waive the benefits of the treaty.

Exceptions to an individual’s classification as a covered expatriate are provided in two situations. The first exception applies to an individual who was born with citizenship both in the United States and in another country; provided that (1) as of the expatriation date the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual was not a resident of the United States for the five taxable years ending with the year of expatriation. The second exception applies to a U.S. citizen who relinquishes U.S. citizenship before reaching age 18 and a half, provided that the individual was a resident of the United States for no more than five taxable years before such relinquishment.

For purposes of the mark-to-market tax, an individual is treated as having relinquished U.S. citizenship on the earliest of four possible dates: (1) the date that the individual renounces U.S. nationality before a diplomatic or consular officer of the United States (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (2) the date that the individual furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act (again, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality); (3) the date that the State Department issues a certificate of loss of nationality; or (4) the date that a U.S. court cancels a naturalized citizen’s certificate of naturalization.

In addition, the proposal provides that, for all tax purposes (i.e., not limited to the mark-to-market tax), a U.S. citizen continues to be treated as a U.S. citizen for tax purposes until that individual’s citizenship is treated as relinquished under the rules of the immediately preceding paragraph. However, under Treasury regulations, relinquishment may occur earlier with respect to an individual who became at birth a citizen of the United States and of another country.

### **Election to be treated as a U.S. citizen**

Under the proposal, a covered expatriate is permitted to make an irrevocable election to continue to be taxed as a U.S. citizen with respect to all property that otherwise is covered by the

expatriation tax. This election is an “all or nothing” election; an individual is not permitted to elect this treatment for some property but not for other property. The election, if made, applies to all property that would be subject to the expatriation tax and to any property the basis of which is determined by reference to such property. Under this election, following expatriation the individual continues to pay U.S. income taxes at the rates applicable to U.S. citizens on any income generated by the property and on any gain realized on the disposition of the property. In addition, the property continues to be subject to U.S. gift, estate, and generation-skipping transfer taxes. In order to make this election, the taxpayer is required to waive any treaty rights that would preclude the collection of the tax.

The individual is also required to provide security to ensure payment of the tax under this election in such form, manner, and amount as the Secretary of the Treasury requires. The amount of mark-to-market tax that would have been owed but for this election (including any interest, penalties, and certain other items) becomes a lien in favor of the United States on all U.S.-situs property owned by the individual. This lien arises on the expatriation date and continues until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary of the Treasury is satisfied that no further tax liability may arise by reason of this proposal. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to liens arising under this proposal.

#### **Deemed sale of property upon expatriation or residency termination and tentative tax**

The deemed sale rule of the proposal generally applies to all property interests held by the individual on the date of relinquishment of citizenship or termination of residency. Special rules apply in the case of trust interests, as described below. U.S. real property interests, which remain subject to U.S. tax in the hands of nonresident noncitizens, generally are excepted from the proposal. Regulatory authority is granted to the Treasury to except other types of property from the proposal.

Under the proposal, an individual who is subject to the mark-to-market tax is required to pay a tentative tax equal to the amount of tax that would be due for a hypothetical short tax year ending on the date the individual relinquished citizenship or terminated residency. Thus, the tentative tax is based on all income, gains, deductions, losses, and credits of the individual for the year through such date, including amounts realized from the deemed sale of property. Moreover, notwithstanding any other provision of the Code, any period during which recognition of income or gain had been deferred terminates on the day before relinquishment of citizenship or termination of residency (and, therefore, such income or gain recognition becomes part of the tax base of the tentative tax). The tentative tax is due on the 90<sup>th</sup> day after the date of relinquishment of citizenship or termination of residency, subject to the election, described below, to defer payments of the mark-to-market tax. In addition, notwithstanding any other provision of the Code, any extension of time for payment of tax ceases to apply on the day before relinquishment of citizenship or termination of residency, and the unpaid portion of such tax becomes due and payable at the time and in the manner prescribed by the Secretary of the Treasury.

## **Deferral of payment of mark-to-market tax**

Under the proposal, an individual is permitted to elect to defer payment of the mark-to-market tax imposed on the deemed sale of property. Interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. The election is irrevocable and is made on a property-by-property basis. Under the election, the mark-to-market tax attributable to a particular property is due when the property is disposed of (or, if the property is disposed of in whole or in part in a nonrecognition transaction, at such other time as the Secretary may prescribe). The mark-to-market tax attributable to a particular property is an amount that bears the same ratio to the total mark-to-market tax for the year as the gain taken into account with respect to such property bears to the total gain taken into account under these rules for the year. The deferral of the mark-to-market tax may not be extended beyond the individual's death.

In order to elect deferral of the mark-to-market tax, the individual is required to provide adequate security to the Treasury to ensure that the deferred tax and interest will be paid. Other security mechanisms are permitted provided that the individual establishes to the satisfaction of the Secretary that the security is adequate. In the event that the security provided with respect to a particular property subsequently becomes inadequate and the individual fails to correct the situation, the deferred tax and the interest with respect to such property will become due. As a further condition to making the election, the individual is required to consent to the waiver of any treaty rights that would preclude the collection of the tax.

The deferred amount (including any interest, penalties, and certain other items) becomes a lien in favor of the United States on all U.S.-situs property owned by the individual. This lien arises on the expatriation date and continues until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this proposal. The rules of section 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to such liens.

## **Retirement plans and similar arrangements**

Subject to certain exceptions, the proposal applies to all property interests held by covered expatriates at the time of relinquishment of citizenship or termination of residency. Accordingly, such property includes an interest in an employer-sponsored qualified plan or deferred compensation arrangement as well as an interest in an individual retirement account or annuity (i.e., an IRA).<sup>172</sup> However, the proposal contains a special rule for an interest in a "retirement plan." For purposes of the proposal, a "retirement plan" includes an employer-sponsored qualified plan (sec. 401(a)), a qualified annuity (sec. 403(a)), a tax-sheltered annuity (sec. 403(b)), an eligible deferred compensation plan of a governmental employer (sec. 457(b)), or an IRA (sec. 408). The special retirement plan rule applies also, to the extent provided in

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<sup>172</sup> Application of the proposal is not limited to an interest that meets the definition of property under section 83 (relating to property transferred in connection with the performance of services).

regulations, to any foreign plan or similar retirement arrangement or program. An interest in a trust that is part of a retirement plan or other arrangement that is subject to the special retirement plan rule is not subject to the rules for interests in trusts (discussed below).

Under the special rule, an amount equal to the present value of the individual's vested, accrued benefit under a retirement plan is treated as having been received by the individual as a distribution under the retirement plan on the day before the individual's relinquishment of citizenship or termination of residency. It is not intended that the retirement plan would be deemed to have made a distribution for purposes of the tax-favored status of the retirement plan, such as whether a plan may permit distributions before a participant has severed employment. In the case of any later distribution to the individual from the retirement plan, the amount otherwise includible in the individual's income as a result of the distribution is reduced to reflect the amount previously included in income under the special retirement plan rule. The amount of the reduction applied to a distribution is the excess of: (1) the amount included in income under the special retirement plan rule over (2) the total reductions applied to any prior distributions. However, under the proposal, the retirement plan, and any person acting on the plan's behalf, will treat any later distribution in the same manner as the distribution would be treated without regard to the special retirement plan rule.

It is expected that the Treasury Department will provide guidance for determining the present value of an individual's vested, accrued benefit under a qualified retirement plan, such as the individual's account balance in the case of a defined contribution plan or an IRA, or present value determined under the qualified joint and survivor annuity rules applicable to a defined benefit plan (sec. 417(e)).

### **Interests in trusts**

Detailed rules apply under the proposal to trust interests held by an individual at the time of relinquishment of citizenship or termination of residency. The treatment of trust interests depends on whether the trust is a "qualified trust." A trust is a qualified trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust.

Constructive ownership rules apply to a trust beneficiary that is a corporation, partnership, trust, or estate. In such cases, the shareholders, partners, or beneficiaries of the entity are deemed to be the direct beneficiaries of the trust. In addition, an individual who holds (or who is treated as holding) a trust instrument at the time of relinquishment of citizenship or termination of residency is required to disclose on his or her tax return the methodology used to determine his or her interest in the trust, and whether such individual knows (or has reason to know) that any other beneficiary of the trust uses a different method.

Nonqualified trusts.—If an individual holds an interest in a trust that is not a qualified trust, a special rule applies for purposes of determining the amount of the mark-to-market tax due with respect to such trust interest. The individual's interest in the trust is treated as a separate trust consisting of the trust assets allocable to such interest. Such separate trust is treated as having sold its net assets on the day before the date of relinquishment of citizenship or termination of residency and having distributed the assets to the individual, who then is treated as

having recontributed the assets to the trust. The individual is subject to the mark-to-market tax with respect to any net income or gain arising from the deemed distribution from the trust.

The election to defer payment is available for the mark-to-market tax attributable to a nonqualified trust interest. A beneficiary's interest in a nonqualified trust is determined under all the facts and circumstances, including the trust instrument, letters of wishes, historical patterns of trust distributions, and the existence of, and function performed by, a trust protector or any similar advisor.

Qualified trusts.—If an individual has an interest in a qualified trust, the amount of mark-to-market tax on unrealized gain allocable to the individual's trust interest is calculated at the time of expatriation or residency termination, as if the individual directly held all the assets allocable to such interest. If any individual's interest in a trust is vested as of the day before the expatriation date (e.g., if the individual's interest in the trust is non-contingent and non-discretionary), the gain allocable to the individual's trust interest is determined based on the trust assets allocable to his or her trust interest. If the individual's interest in the trust is not vested as of the expatriation date (e.g., if the individual's trust interest is a contingent or discretionary interest), the gain allocable to his or her trust interest is determined based on all of the trust assets that could be allocable to his or her trust interest, determined by resolving all contingencies and discretionary powers in the individual's favor (i.e., the individual is allocated the maximum amount that he or she could receive).

In general, the mark-to-market tax, as calculated above, is collected when the individual receives distributions from the qualified trust. Beginning on the 91<sup>st</sup> day after the expatriation date, interest is charged for the period the tax is deferred at a rate two percentage points higher than the rate normally applicable to individual underpayments. These distributions also may be subject to other U.S. income taxes. If a distribution from a qualified trust is made after the individual relinquishes citizenship or terminates residency, the mark-to-market tax is imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates, but in no event will the tax imposed exceed the "deferred tax amount" with respect to the trust interest. For this purpose, the deferred tax amount is equal to (1) the tax calculated with respect to the unrealized gain allocable to the trust interest at the time of expatriation or residency termination, (2) increased by interest as described above, calculated up to 30 days prior to the date of the distribution, (3) reduced by any mark-to-market tax imposed on prior trust distributions to the individual, and (4) to the extent provided in Treasury regulations, in the case of a covered expatriate holding a nonvested interest, reduced by mark-to-market taxes imposed on trust distributions to other persons holding nonvested interests.

The tax that is imposed on distributions from a qualified trust generally is to be deducted and withheld by the trustees. If the individual does not agree to waive treaty rights that would preclude collection of the tax, the tax with respect to such distributions is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against such individual with respect to the tax.

Mark-to-market taxes become due if the trust ceases to be a qualified trust, the individual disposes of his or her qualified trust interest, or the individual dies. In such cases, the amount of mark-to-market tax equals the lesser of (1) the tax calculated under the rules for nonqualified

trust interests as of the date of the triggering event, or (2) the deferred tax amount with respect to the trust interest immediately before that date. Such tax is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against such individual (or his or her estate) with respect to such tax.

### **Coordination with present-law alternative tax regime**

The proposal provides a coordination rule with the present-law alternative tax regime. Under the proposal, the expatriation income tax rules under section 877, and the special expatriation estate and gift tax rules under sections 2107 and 2501(a)(3) (described above), do not apply to a covered expatriate whose expatriation or residency termination occurs on or after the date of enactment.

### **Regulatory authority**

The proposal authorizes the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 877A.

### **Income tax treatment of gifts and inheritances from a former citizen or former long-term resident**

Under the proposal, the exclusion from income provided in section 102 (relating to exclusions from income for the value of property acquired by gift or inheritance) does not apply to the value of any property received by gift or inheritance from a covered expatriate. Accordingly, a U.S. taxpayer who receives a gift or inheritance from such an individual is required to include the value of such gift or inheritance in gross income and is subject to U.S. tax on such amount. Having included the value of the property in income, the recipient takes a basis in the property equal to that value. The tax does not apply to property that is shown on a timely filed gift tax return and that is a taxable gift by the former citizen or former long-term resident, or property that is shown on a timely filed estate tax return and included in the gross U.S. estate of the former citizen or former long-term resident (regardless of whether the tax liability shown on such a return is reduced by credits, deductions, or exclusions available under the estate and gift tax rules). In addition, the tax does not apply to property in cases in which no estate or gift tax return was filed, but no such return would have been required to be filed if the former citizen or former long-term resident had not relinquished citizenship or terminated residency, as the case may be.

### **Information reporting**

The proposal provides that certain information reporting requirements under present law (sec. 6039G) applicable to former citizens and former long-term residents also apply for purposes of the proposal.

### **Immigration rules**

The proposal denies former citizens reentry into the United States if the individual is determined not to be in compliance with his or her tax obligations under the proposal's expatriation tax rules (regardless of the subjective motive for expatriating). For this purpose, the

proposal permits the IRS to disclose certain items of return information of an individual, upon written request of the Attorney General or his delegate, as is necessary for making a determination under section 212(a)(10)(E) of the Immigration and Nationality Act. Specifically, the proposal permit the IRS to disclose to the agency administering section 212(a)(10)(E) whether such taxpayer is in compliance with section 877A and identify the items of noncompliance. Recordkeeping requirements, safeguards, and civil and criminal penalties for unauthorized disclosure or inspection apply to return information disclosed under this proposal.

### **Effective Date**

The proposal generally is effective for U.S. citizens who relinquish citizenship or long-term residents who terminate their residency on or after the date of enactment. The due date for tentative tax, however, may not occur before the 90<sup>th</sup> day after the date of enactment. The proposal relating to income taxes on gifts and inheritances is effective for gifts and inheritances received from former citizens and former long-term residents on or after the date of enactment, whose relinquishment of citizenship or residency termination occurs after such date. The immigration and disclosure proposals relating to former citizens are effective with respect to individuals who relinquish citizenship on or after the date of enactment.

## F. Miscellaneous Provisions

### 1. Treatment of contingent payment convertible debt instruments

#### Present Law

Under present law, a taxpayer generally deducts the amount of interest paid or accrued within the taxable year on indebtedness issued by the taxpayer. In the case of original issue discount (“OID”), the issuer of a debt instrument generally accrues and deducts, as interest, the OID over the life of the obligation, even though the amount of the OID may not be paid until the maturity of the instrument.

The amount of OID with respect to a debt instrument is equal to the excess of the stated redemption price at maturity over the issue price of the debt instrument. The stated redemption price at maturity includes all amounts that are payable on the debt instrument by maturity. The amount of OID with respect to a debt instrument is allocated over the life of the instrument through a series of adjustments to the issue price for each accrual period. The adjustment to the issue price is determined by multiplying the adjusted issue price (i.e., the issue price increased or decreased by adjustments prior to the accrual period) by the instrument’s yield to maturity, and then subtracting any payments on the debt instrument (other than non-OID stated interest) during the accrual period. Thus, in order to compute the amount of OID and the portion of OID allocable to a particular period, the stated redemption price at maturity and the time of maturity must be known. Issuers of debt instruments with OID accrue and deduct the amount of OID as interest expense in the same manner as the holders of such instruments accrue and include in gross income the amount of OID as interest income.

Treasury regulations provide special rules for determining the amount of OID allocated to a period with respect to certain debt instruments that provide for one or more contingent payments of principal or interest.<sup>173</sup> The regulations provide that a debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt instrument into the stock of the issuer, into the stock or debt of a related party, or into cash or other property in an amount equal to the approximate value of such stock or debt.<sup>174</sup> The regulations also provide that a payment is not a contingent payment merely because of a contingency that, as of the issue date of the debt instrument, is either remote or incidental.<sup>175</sup>

In the case of contingent payment debt instruments that are issued for money or publicly traded property,<sup>176</sup> the regulations provide that interest on a debt instrument must be taken into account (as OID) whether or not the amount of any payment is fixed or determinable in the

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<sup>173</sup> Treas. reg. sec. 1.1275-4.

<sup>174</sup> Treas. reg. sec. 1.1275-4(a)(4).

<sup>175</sup> Treas. reg. sec. 1.1275-4(a)(5).

<sup>176</sup> Treas. reg. sec. 1.1275-4(b).

taxable year. The amount of OID that is taken into account for each accrual period is determined by constructing a comparable yield and a projected payment schedule for the debt instrument, and then accruing the OID on the basis of the comparable yield and projected payment schedule by applying rules similar to those for accruing OID on a noncontingent debt instrument (the “noncontingent bond method”). If the actual amount of a contingent payment is not equal to the projected amount, appropriate adjustments are made to reflect the difference. The comparable yield for a debt instrument is the yield at which the issuer would be able to issue a fixed-rate noncontingent debt instrument with terms and conditions similar to those of the contingent payment debt instrument (i.e., the comparable fixed-rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions.<sup>177</sup>

With respect to certain debt instruments that are convertible into the common stock of the issuer and that also provide for contingent payments (other than the conversion feature) -- often referred to as “contingent convertible” debt instruments -- the IRS has stated that the noncontingent bond method applies in computing the accrual of OID on the debt instrument.<sup>178</sup> In applying the noncontingent bond method, the IRS has stated that the comparable yield for a contingent convertible debt instrument is determined by reference to a comparable fixed-rate nonconvertible debt instrument, and the projected payment schedule is determined by treating the issuer stock received upon a conversion of the debt instrument as a contingent payment.

### **Description of Proposal**

The proposal provides that, in the case of a contingent convertible debt instrument,<sup>179</sup> any Treasury regulations which require OID to be determined by reference to the comparable yield of a noncontingent fixed-rate debt instrument shall be applied as requiring that such comparable yield be determined by reference to a noncontingent fixed-rate debt instrument which is convertible into stock. For purposes of applying the proposal, the comparable yield shall be determined without taking into account the yield resulting from the conversion of a debt instrument into stock. Thus, the noncontingent bond method in the Treasury regulations shall be applied in a manner such that the comparable yield for contingent convertible debt instruments shall be determined by reference to comparable noncontingent fixed-rate convertible (rather than nonconvertible) debt instruments.

### **Effective Date**

The proposal is effective for debt instruments issued on or after date of enactment.

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<sup>177</sup> Treas. Reg. sec. 1.1275-4(b)(4)(i)(A).

<sup>178</sup> Rev. Rul. 2002-31, 2002-1 C.B. 1023.

<sup>179</sup> Under the proposal, a contingent convertible debt instrument is defined as a debt instrument that: (1) is convertible into stock of the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation; and (2) provides for contingent payments.

## **2. Grant Treasury regulatory authority to address foreign tax credit transactions involving inappropriate separation of foreign taxes from related foreign income**

### **Present Law**

The United States employs a “worldwide” tax system, under which residents generally are taxed on all income, whether derived in the United States or abroad. In order to mitigate the possibility of double taxation arising from overlapping claims of the United States and a source country to tax the same item of income, the United States provides a credit for foreign income taxes paid or accrued, subject to several conditions and limitations.

For purposes of the foreign tax credit, regulations provide that a foreign tax is treated as being paid by “the person on whom foreign law imposes legal liability for such tax.”<sup>180</sup> Thus, for example, if a U.S. corporation owns an interest in a foreign partnership, the U.S. corporation can claim foreign tax credits for the tax that is imposed on it as a partner in the foreign entity. This would be true under the regulations even if the U.S. corporation elected to treat the foreign entity as a corporation for U.S. tax purposes. In such a case, if the foreign entity does not meet the definition of a controlled foreign corporation or does not generate income that is subject to current inclusion under the rules of subpart F, the income generated by the foreign entity might never be reported on a U.S. return, and yet the U.S. corporation might take the position that it can claim credits for taxes imposed on that income. This is one example of how a taxpayer might attempt to separate foreign taxes from the related foreign income, and thereby attempt to claim a foreign tax credit under circumstances in which there is no threat of double taxation.

### **Description of Proposal**

The proposal provides regulatory authority for the Treasury Department to address transactions that involve the inappropriate separation of foreign taxes from the related foreign income or in which foreign taxes are imposed on any person in respect of income of another person. Regulations issued pursuant to this authority could provide for the disallowance of a credit for all or a portion of the foreign taxes, or for the allocation of the foreign taxes among the participants in the transaction in a manner more consistent with the economics of the transaction.<sup>181</sup>

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<sup>180</sup> Treas. Reg. sec. 1.901-2(f)(1).

<sup>181</sup> It is intended, for example, that the regulations would change the result in the case of *Guardian Industries Corp. v. U.S.*, 65 Fed. Cl. 50, 95 A.F.T.R.2d 05-1692 (Ct. Fed. Cl. Mar. 31, 2005). In that case, the court held that the American parent of a Luxembourg hybrid entity was entitled to a direct foreign tax credit for Luxembourg income tax paid or accrued by the subsidiary with respect to the taxable income of a group of Luxembourg subsidiaries that were consolidated for Luxembourg tax purposes. Under Luxembourg law, the subsidiary was the parent company of the Luxembourg group and was solely liable for the Luxembourg income taxes of its consolidated group.

### **Effective Date**

The proposal generally is effective for transactions entered into after the date of enactment.

### **3. Repeal of special property exception to the leasing provisions of the American Jobs Creation Act of 2004**

#### **Present Law**

Present law provides for the deferral of losses attributable to certain tax exempt use property, generally effective for leases entered into after March 12, 2004. However, the deferral provision does not apply to property located in the United States that is subject to a lease with respect to which a formal application: (1) was submitted for approval to the Federal Transit Administration (an agency of the Department of Transportation) after June 30, 2003, and before March 13, 2004; (2) is approved by the Federal Transit Administration before January 1, 2006; and (3) includes a description and the fair market value of such property (the “qualified transportation property exception”).

#### **Description of Proposal**

The proposal repeals the qualified transportation property exception.

#### **Effective Date**

The proposal is effective as if included in the included in the provisions of the American Jobs Creation Act of 2004 to which it relates.

### **4. Application of earnings stripping rules to partners which are corporations**

#### **Present Law**

Present law provides rules to limit the ability of U.S. corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Section 163(j) specifically addresses earnings stripping involving interest payments, by limiting the deductibility of interest paid to certain related parties (“disqualified interest”),<sup>182</sup> if the payor’s debt-equity ratio exceeds 1.5 to 1 and the payor’s net interest expense exceeds 50 percent of its “adjusted taxable income” (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Disallowed interest amounts can be carried forward indefinitely. In addition, excess limitation (i.e., any excess of the 50-percent limit over a company’s net interest expense for a given year) can be carried forward three years.

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<sup>182</sup> This interest also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.

Proposed Treasury regulations provide that a partner's proportionate share of partnership liabilities is treated as liabilities incurred directly by the partner, for purposes of applying the earnings stripping limitation to interest payments by a corporate partner of a partnership.<sup>183</sup> The proposed Treasury regulations provide that interest paid or accrued to a partnership is treated as paid or accrued to the partners of the partnership in proportion to each partner's distributive share of the partnership's interest income for the taxable year.<sup>184</sup> In addition, the proposed Treasury regulations provide that interest expense paid or accrued by a partnership is treated as paid or accrued by the partners of the partnership in proportion to each partner's distributive share of the partnership's interest expense.<sup>185</sup>

### **Description of Proposal**

The proposal codifies the approach of the proposed Treasury regulations by providing that, except to the extent provided by regulations, in the case of a corporation that owns, directly or indirectly, an interest in a partnership, the corporation's share of partnership liabilities is treated as liabilities of the corporation for purposes of applying the earnings stripping rules to the corporation. The proposal provides that the corporation's distributive share of interest income of the partnership, and of interest expense of the partnership, is treated as interest income or interest expense of the corporation.

The proposal provides Treasury regulatory authority to reallocate shares of partnership debt, or distributive shares of the partnership's interest income or interest expense, as may be appropriate to carry out the purposes of the proposal. For example, it is not intended that the application of the earnings stripping rules to corporations with direct or indirect interests in partnerships be circumvented through the use of allocations of partnership interest income or expense (or partnership liabilities) to or away from partners.

### **Effective Date**

The proposal is effective for taxable years beginning on or after the date of enactment.

## **5. Prohibition on deferral of certain stock option and restricted stock gains**

### **Present Law**

Section 83 applies to transfers of property in connection with the performance of services. Under section 83, if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of such property over the amount (if any) paid for the property is

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<sup>183</sup> Prop. Treas. reg. sec. 1.163(j)-3(b)(3).

<sup>184</sup> Prop. Treas. Reg. sec. 1.163(j)-2(e)(4).

<sup>185</sup> Prop. Treas. Reg. sec. 1.163(j)-2(e)(5).

includible in income at the first time that the property is transferable or not subject to substantial risk of forfeiture.

Stock granted to an employee (or other service provider) is subject to the rules that apply under section 83. When stock is vested and transferred to an employee, the excess of the fair market value of the stock over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which the transfer occurs.

The income taxation of a nonqualified stock option is determined under section 83 and depends on whether the option has a readily ascertainable fair market value. If the nonqualified option does not have a readily ascertainable fair market value at the time of grant, no amount is includible in the gross income of the recipient with respect to the option until the recipient exercises the option. The transfer of stock on exercise of the option is subject to the general rules of section 83. That is, if vested stock is received on exercise of the option, the excess of the fair market value of the stock over the option price is includible in the recipient's gross income as ordinary income in the taxable year in which the option is exercised. If the stock received on exercise of the option is not vested, the excess of the fair market value of the stock at the time of vesting over the option price is includible in the recipient's income for the year in which vesting occurs unless the recipient elects to apply section 83 at the time of exercise. Other forms of stock-based compensation are also subject to the rules of section 83.

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangements. In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture. In addition, nonqualified deferred compensation is subject to requirements under section 409A. Under section 409A, amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied. Requirements exist with regard to permissible distributions, elections, and acceleration of benefits.

### **Description of Proposal**

Under the proposal, gains attributable to stock options (including exercises of stock options), vesting of restricted stock, and other compensation based on employer securities (including employer securities) cannot be deferred by exchanging such amounts for a right to receive a future payment. Except as provided by the Secretary, if a taxpayer exchanges (1) an option to purchase employer securities, (2) employer securities, or (3) any other property based on employer securities for a right to receive future payments, an amount equal to the present value of such right (or such other amount as the Secretary specifies) is required to be included in gross income for the taxable year of the exchange. The proposal applies even if the future right to payment is treated as an unfunded and unsecured promise to pay. The proposal applies when

there is in substance an exchange, even if the transaction is not formally structured as an exchange.

The proposal is not intended to imply that such practices result in permissive deferral of income under present law.

### **Effective Date**

The proposal is effective for exchanges after the date of enactment.

## **6. Limitation on employer deduction for certain entertainment expenses**

### **Present Law**

#### **In general**

Under present law, no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement or recreation, unless the taxpayer establishes that the item was directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business, or (2) a facility (e.g., an airplane) used in connection with such activity.<sup>186</sup> The Code includes a number of exceptions to the general rule disallowing deductions of entertainment expenses. Under one exception, the deduction disallowance rule does not apply to expenses for goods, services, and facilities to the extent that the expenses are reported by the taxpayer as compensation and wages to an employee.<sup>187</sup> The deduction disallowance rule also does not apply to expenses paid or incurred by the taxpayer for goods, services, and facilities to the extent that the expenses are includible in the gross income of a recipient who is not an employee (e.g., a nonemployee director) as compensation for services rendered or as a prize or award.<sup>188</sup> The exceptions apply only to the extent that amounts are properly reported by the company as compensation and wages or otherwise includible in income. In no event can the amount of the deduction exceed the amount of the actual cost, even if a greater amount is includible in income.

Except as otherwise provided, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. In general, an employee or other service provider must include in gross income the amount by which the fair value of a fringe benefit exceeds the amount paid by the individual. Treasury regulations provide rules regarding the valuation of fringe benefits, including flights on an employer-provided aircraft.<sup>189</sup> In general, the value of a non-commercial flight is determined under the base aircraft valuation formula, also

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<sup>186</sup> Sec. 274(a).

<sup>187</sup> Sec. 274(e)(2). As discussed below, a special rule applies in the case of specified individuals.

<sup>188</sup> Sec. 274(e)(9).

<sup>189</sup> Treas. Reg. sec. 1.61-21.

known as the Standard Industry Fare Level formula or “SIFL”.<sup>190</sup> If the SIFL valuation rules do not apply, the value of a flight on a company-provided aircraft is generally equal to the amount that an individual would have to pay in an arm’s-length transaction to charter the same or a comparable aircraft for that period for the same or a comparable flight.<sup>191</sup>

In the context of an employer providing an aircraft to employees for nonbusiness (e.g., vacation) flights, the exception for expenses treated as compensation was interpreted in *Sutherland Lumber-Southwest, Inc. v. Commissioner* (“*Sutherland Lumber*”) as not limiting the company’s deduction for operation of the aircraft to the amount of compensation reportable to its employees,<sup>192</sup> which can result in a deduction many times larger than the amount required to be included in income. In many cases, the individual including amounts attributable to personal travel in income directly benefits from the enhanced deduction, resulting in a net deduction for the personal use of the company aircraft.

### **Specified individuals**

In the case of specified individuals, the exceptions to the general entertainment expense disallowance rule for expenses treated as compensation or includible in income apply only to the extent of the amount of expenses treated as compensation or includible in income of the specified individual. For example, a company’s deduction attributable to aircraft operating costs and other expenses for a specified individual’s vacation use of a company aircraft is limited to the amount reported as compensation to the specified individual. *Sutherland Lumber* was overturned with respect to specified individuals.

Specified individuals are individuals who, with respect to an employer or other service recipient, are subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934, or would be subject to such requirements if the employer or service recipient were an issuer of equity securities referred to in section 16(a). Such individuals generally include officers (as defined by section 16(a)),<sup>193</sup> directors, and 10-percent-or-greater owners of private and publicly-held companies.

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<sup>190</sup> Treas. Reg. sec. 1.61-21(g).

<sup>191</sup> Treas. Reg. sec. 1.61-21(b)(6).

<sup>192</sup> *Sutherland Lumber-Southwest, Inc. v. Comm.*, 114 T.C. 197 (2000), *aff’d*, 255 F.3d 495 (8th Cir. 2001), *acq.*, AOD 2002-02 (Feb. 11, 2002).

<sup>193</sup> An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

## Description of Proposal

Under the proposal, in the case of all individuals, the exceptions to the general entertainment expense disallowance rule for expenses treated as compensation or includible in income apply only to the extent of the amount of expenses treated as compensation or includible in income. Thus, under those exceptions, no deduction is allowed with respect to expenses for (1) a nonbusiness activity generally considered to be entertainment, amusement or recreation, or (2) a facility (e.g., an airplane) used in connection with such activity to the extent that such expenses exceed the amount treated as compensation or includible in income. The proposal is intended to overturn *Sutherland Lumber* for all individuals. As under present law, the exceptions apply only if amounts are properly reported by the company as compensation and wages or otherwise includible in income.

## Effective Date

The proposal is effective for expenses incurred after the date of enactment.

## **7. Elimination of double deduction of mining exploration and development costs under the minimum tax**

### Present Law

Under present law, mining development costs are expensed in computing taxable income, unless either the deferred expense method is elected under section 616(b) or 10-year amortization is elected under section 59(e). In addition, a taxpayer may elect to expense mining exploration costs under section 617 or amortize the costs over a 10-year period under section 59(e). Also, a deduction for depletion is allowed with respect to mines. One method of computing the allowance for depletion is the percentage depletion method under section 613 that is based on the income of the mining property and is not limited by the adjusted basis of the property.

In determining alternative minimum taxable income (“AMTI”) mining exploration and development costs with respect to a mine are required to be capitalized and amortized over a 10-year period, unless the deferred expense method is elected under section 616(b).<sup>194</sup> In addition, the deduction for percentage depletion is limited to the adjusted basis of the property at the end of the taxable year (without regard to the depletion deduction for the year).<sup>195</sup> Treasury regulations<sup>196</sup> provide that the adjusted basis for this purpose is the same as the adjusted basis for purposes of determining gain or loss from the sale or other disposition of the property. Treasury regulations<sup>197</sup> further provide that the expenditures for development and exploration of mines

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<sup>194</sup> Sec. 56(a)(2).

<sup>195</sup> Sec. 57(a)(1).

<sup>196</sup> Treas. Reg. sec. 1-57-1(h)(3).

<sup>197</sup> Treas. Reg. sec. 1016-5(f).

treated as deferred expenses are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate. The adjusted basis of the property is reduced by depletion deductions and the deductions for mining and exploration expenses in the taxable year the deductions are allowable.

Under the rules, notwithstanding the adjusted basis limitation on percentage depletion, a taxpayer may deduct more than 100 percent of its exploration and development costs in computing AMTI. For example, assume a taxpayer incurs \$1 million in development costs in 2005 with respect to a mine that has a zero basis and that the deferred expense method is not elected. Also, assume that the deduction for percentage depletion (without regard to the basis limitation) for 2005 is \$900,000. Under present law, in computing AMTI, the taxpayer is allowed to deduct \$100,000 per year in development costs for each of the 10 taxable years beginning in 2005, and, in addition, is allowed to deduct percentage depletion of \$900,000 in 2005, for a total of \$1.9 million in deductions.

### **Description of Proposal**

Under the proposal, the deduction for depletion under the alternative minimum tax is amended by excluding from the adjusted basis of any mining property, the amount of mining exploration and development costs that may be allowed as a deduction to the taxpayer in computing AMTI in a future taxable year.

In the example described under present law, the \$1 million development costs will be amortized over a 10-year period and no amount will be allowed as a deduction for depletion in computing AMTI.<sup>198</sup>

### **Effective Date**

The proposal applies to taxable years beginning after the date of enactment.

## **8. Increase in age of minor children whose unearned income is taxed as if parent's income**

### **Present Law**

#### **Filing requirements for children**

A single unmarried individual eligible to be claimed as a dependent on another taxpayer's return generally must file an individual income tax return if he or she has: (1) earned income only over \$5,000 (for 2005); (2) unearned income only over the minimum standard deduction amount for dependents (\$800 in 2005); or (3) both earned income and unearned income totaling more than the smaller of (a) \$5,000 (for 2005) or (b) the larger of (i) \$800 (for 2005), or (ii)

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<sup>198</sup> If the taxpayer elects the deferred expense method under section 616(b) or 10-year amortization under section 59(e), the deduction for depletion will also be zero.

earned income plus \$250.<sup>199</sup> Thus, if a dependent child has less than \$800 in gross income, the child does not have to file an individual income tax return for 2005.<sup>200</sup>

A child who cannot be claimed as a dependent on another person's tax return (e.g., because the support test is not satisfied by any other person) is subject to the generally applicable filing requirements. That is, such an individual generally must file a return if the individual's gross income exceeds the sum of the standard deduction and the personal exemption amounts applicable to the individual.

### **Taxation of unearned income under section 1(g)**

Special rules (generally referred to as the "kiddie tax") apply to the unearned income of a child who is under age 14.<sup>201</sup> The kiddie tax applies if: (1) the child has not reached the age of 14 by the close of the taxable year; (2) the child's unearned income was more than \$1,600 (for 2005); and (3) the child is required to file a return for the year. The kiddie tax applies regardless of whether the child may be claimed as a dependent on the parent's return.

For these purposes, unearned income is income other than wages, salaries, professional fees, or other amounts received as compensation for personal services actually rendered.<sup>202</sup> For children under age 14, net unearned income (for 2005, generally unearned income over \$1,600) is taxed at the parent's rate if the parent's rate is higher than the child's rate. The remainder of a child's taxable income (i.e., earned income, plus unearned income up to \$1,600 (for 2005), less the child's standard deduction) is taxed at the child's rates, regardless of whether the kiddie tax applies to the child. In general, a child is eligible to use the preferential tax rates for qualified dividends and capital gains.<sup>203</sup>

The kiddie tax is calculated by computing the "allocable parental tax." This involves adding the net unearned income of the child to the parent's income and then applying the parent's tax rate. A child's "net unearned income" is the child's unearned income less the sum of (1) the minimum standard deduction allowed to dependents (\$800 for 2005), and (2) the

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<sup>199</sup> Sec. 6012(a)(1)(C). Other filing requirements apply to dependents who are married, elderly, or blind. See, Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 2, Table 1 (2005).

<sup>200</sup> A taxpayer generally need not file a return if he or she has gross income in an amount less than the standard deduction (and, if allowable to the taxpayer, the personal exemption amount). An individual who may be claimed as a dependent of another taxpayer is not eligible to claim the dependency exemption relating to that individual. Sec. 151(d)(2). For taxable years beginning in 2005, the standard deduction amount for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of \$800 or the sum of \$250 and the individual's earned income.

<sup>201</sup> Sec. 1(g).

<sup>202</sup> Sec. 1(g)(4) and sec. 911(d)(2).

<sup>203</sup> Sec. 1(h).

greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized deductions that are directly connected with the production of the unearned income.<sup>204</sup> A child's net unearned income cannot exceed the child's taxable income.

The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parent's taxable income. If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase, based upon the child's net unearned income relative to the aggregate net unearned income of all of the parent's children subject to the tax.

Special rules apply to determine which parent's tax return and rate is used to calculate the kiddie tax. If the parents file a joint return, the allocable parental tax is calculated using the income reported on the joint return. In the case of parents who are married but file separate returns, the allocable parental tax is calculated using the income of the parent with the greater amount of taxable income. In the case of unmarried parents, the child's custodial parent is the parent whose taxable income is taken into account in determining the child's liability. If the custodial parent has remarried, the stepparent is treated as the child's other parent. Thus, if the custodial parent and stepparent file a joint return, the kiddie tax is calculated using that joint return. If the custodial parent and stepparent file separate returns, the return of the one with the greater taxable income is used. If the parents are unmarried but lived together all year, the return of the parent with the greater taxable income is used.<sup>205</sup>

Unless the parent elects to include the child's income on the parent's return (as described below) the child files a separate return to report the child's income.<sup>206</sup> In this case, items on the parent's return are not affected by the child's income. The total tax due from a child is the greater of:

- (1) the sum of (a) the tax payable by the child on the child's earned income plus (b) the allocable parental tax on the child's unearned income, or
- (2) the tax on the child's income without regard to the kiddie tax provisions.

### **Parental election to include child's dividends and interest on parent's return**

Under certain circumstances, a parent may elect to report a child's dividends and interest on the parent's return. If the election is made, the child is treated as having no income for the year and the child does not have to file a return. The parent makes the election on Form 8814,

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<sup>204</sup> Sec. 1(g)(4).

<sup>205</sup> Sec. 1(g)(5); Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 6 (2005).

<sup>206</sup> The child must attach to the return Form 8615, *Tax for Children Under Age 14 With Investment Income of More Than \$1,500* (2003).

Parents' Election To Report Child's Interest and Dividends. The requirements for the parent's election are that:

- (1) the child has gross income only from interest and dividends (including capital gains distributions and Alaska Permanent Fund Dividends),<sup>207</sup>
- (2) such income is more than the minimum standard deduction amount for dependents (\$800 in 2004) and less than 10 times that amount (\$8000 in 2004);
- (3) no estimated tax payments for the year were made in the child's name and taxpayer identification number;
- (4) no backup withholding occurred; and
- (5) the child is required to file a return if the parent does not make the election.

Only the parent whose return must be used when calculating the kiddie tax may make the election. The parent includes in income the child's gross income in excess of twice the minimum standard deduction amount for dependents (i.e., the child's gross income in excess of \$1,600 for 2005). This amount is taxed at the parent's rate. The parent also must report an additional tax liability equal to the lesser of: (1) \$80 (in 2005), or (2) 10 percent of the child's gross income exceeding the child's standard deduction (\$800 in 2005).

Including the child's income on the parent's return can affect the parent's deductions and credits that are based on adjusted gross income, as well as income-based phaseouts, limitations, and floors.<sup>208</sup> In addition, certain deductions that the child would have been entitled to take on his or her own return are lost.<sup>209</sup> Further, if the child received tax-exempt interest from a private activity bond, that item is considered a tax preference of the parent for alternative minimum tax purposes.<sup>210</sup>

### **Taxation of compensation for services under section 1(g)**

Compensation for a child's services is considered the gross income of the child, not the parent, even if the compensation is not received or retained by the child (e.g. is the parent's income under local law).<sup>211</sup> If the child's income tax is not paid, however, an assessment against

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<sup>207</sup> Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 6 (2005).

<sup>208</sup> Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 7 (2005).

<sup>209</sup> Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents*, at 7 (2005).

<sup>210</sup> Sec. 1(g)(7)(B).

<sup>211</sup> Sec. 73(a).

the child will be considered as also made against the parent to the extent the assessment is attributable to amounts received for the child's services.<sup>212</sup>

### **Description of Proposal**

The proposal increases the age to which the kiddie tax provisions apply from under 14 to under 18 years of age. The proposal also provides an exception to the kiddie tax for distributions from certain qualified disability trusts, defined by cross-reference to sections 1917 and 1614(a)(3) of the Social Security Act.

### **Effective Date**

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

## **9. Modify holding period requirement for qualification for reduced tax rate on dividends on preferred stock**

### **Present Law**

Present law provides that if an individual receives "qualified dividend income," the dividend income is taxed at the same rates as net capital gain. The maximum rate of tax on qualified dividend income therefore generally is 15 percent.<sup>213</sup> Dividends are treated as qualified dividend income only if certain conditions, including holding period requirements, are satisfied. A dividend paid on a share of common stock is qualified dividend income only if the share is held for more than 60 days during the 121-day period beginning on the date that is 60 days before the date on which the share becomes ex-dividend with respect to the dividend.<sup>214</sup> A dividend paid on a share of preferred stock is qualified dividend income only if the share is held for more than 90 days during the 181-day period beginning 90 days before the ex-dividend date.<sup>215</sup>

### **Description of Proposal**

The proposal increases the holding period requirement for treatment as qualified dividend income for dividends paid on preferred stock. Under the proposal, preferred stock must be held for more than 120 days during the 241-day period beginning 120 days before the ex-dividend date.

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<sup>212</sup> Sec. 6201(c).

<sup>213</sup> Sec. 1(h)(1)(C).

<sup>214</sup> Secs. 1(h)(11)(B)(iii)(I), 246(c)(1)(A).

<sup>215</sup> Secs. 1(h)(11)(B)(iii)(I), 246(c)(2).

**Effective Date**

The proposal applies to taxable years beginning after the date of enactment.