AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

[JOINT COMMITTEE PRINT]

# GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 109TH CONGRESS

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

January 17, 2007

JCS–1–00

# GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 109TH CONGRESS

[JOINT COMMITTEE PRINT]

# GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 109TH CONGRESS

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

January 17, 2007

U.S. GOVERNMENT PRINTING OFFICE

31–502 WASHINGTON : 2007 JCS–1–00

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

JOINT COMMITTEE ON TAXATION

109TH CONGRESS, 2ND SESSION

---

| *SENATE* | *HOUSE* |
| --- | --- |
| CHARLES E. GRASSLEY, Iowa<br>*Chairman* | WILLIAM M. THOMAS, California<br>*Vice Chairman* |
| ORRIN G. HATCH, Utah | E. CLAY SHAW, JR., Florida |
| TRENT LOTT, Mississippi | NANCY L. JOHNSON, Connecticut |
| MAX BAUCUS, Montana | CHARLES B. RANGEL, New York |
| JOHN D. ROCKEFELLER IV, West Virginia | FORTNEY PETE STARK, California |

THOMAS A. BARTHOLD, *Acting Chief of Staff*
BERNARD A. SCHMITT, *Deputy Chief of Staff*

## SUMMARY CONTENTS


| | Page |
|---|---|
| Part One: Tsunami Relief (Public Law 109–1) | 4 |
| Part Two: Extension of Leaking Underground Storage Tank Trust Fund Financing Rate (Public Law 109–6) | 5 |
| Part Three: Tax Treatment of Certain Disaster Mitigation Payments (Public Law 109–7) | 6 |
| Part Four: Surface Transportation Extension Act of 2005, Parts I–VI (Public Laws 109–14, 109–20, 109–35, 109–37, 109–40, and 109–42) | 8 |
| Part Five: The Energy Policy Act of 2005 (Public Law 109–58) | 12 |
| Part Six: Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (Public Law 109–59) | 83 |
| Part Seven: Katrina Emergency Tax Relief Act of 2005 (Public Law 109–73) | 131 |
| Part Eight: Sportfishing and Recreational Boating Safety Amendments Act of 2005 (Public Law 109–74) | 163 |
| Part Nine: Gulf Opportunity Zone Act of 2005 (Public Law 109–135) | 165 |
| Part Ten: Extension of Parity in the Application of Certain Limits to Mental Health Benefits (Public Law 109–151) | 257 |
| Part Eleven: Tax Increase Prevention and Reconciliation Act of 2005 (Public Law 109–222) | 259 |
| Part Twelve: Heroes Earned Retirement Opportunities Act (Public Law 109–227) | 327 |
| Part Thirteen: Pension Protection Act of 2006 (Public Law 109–280) | 329 |
| Part Fourteen: Tax Relief and Health Care Act of 2006 (Public Law 109–432) | 661 |

Page

Part Fifteen: Fallen Firefighters Assistance Tax Clarification Act of 2006 (Public Law 109–445) ..... 784

Appendix: Estimated Budget Effects of Tax Legislation Enacted in the 109th Congress ..... 785

# CONTENTS


| | Page |
|---|---|
| **Summary Contents** | III |
| **Introduction** | 1 |
| **Part One: Tsunami Relief (Public Law 109–1)** | 4 |
| A. Acceleration of Income Tax Benefits for Charitable Cash Contributions for Relief of Indian Ocean Tsunami Victims (sec. 1 of the Act) | 4 |
| **Part Two: Extension of Leaking Underground Storage Tank Trust Fund Financing Rate (Public Law 109–6)** | 5 |
| A. Extension of Leaking Underground Storage Tank Trust Fund Financing Rate (sec. 1 of the Act) | 5 |
| **Part Three: Tax Treatment of Certain Disaster Mitigation Payments (Public Law 109–7)** | 6 |
| A. Tax Treatment of Certain Disaster Mitigation Payments (sec. 1 of the Act and sec. 139 of the Code) | 6 |
| **Part Four: Surface Transportation Extension Act of 2005, Parts I–VI (Public Laws 109–14, 109–20, 109–35, 109–37, 109–40, and 109–42)** | 8 |
| A. Extensions of Surface Transportation Act | 8 |
| **Part Five: The Energy Policy Act of 2005 (Public Law 109–58)** | 12 |
| A. Energy Tax Policy Incentives | 12 |
| 1. Extension and modification of renewable electricity production credit (secs. 1301 and 1302 of the Act and sec. 45 of the Code) | 12 |
| 2. Clean renewable energy bonds (sec. 1303 of the Act and new sec. 54 of the Code) | 19 |

Page

3. Treatment of certain income of electric cooperatives (sec. 1304 of the Act and sec. 501(c)(12) of the Code) ..... 23
4. Dispositions of transmission property to implement FERC restructuring policy (sec. 1305 of the Act and sec. 451 of the Code) ..... 27
5. Credit for production from advanced nuclear power facilities (sec. 1306 of the Act and new sec. 45J of the Code) ..... 28
6. Credit for investment in clean coal facilities (sec. 1307 of the Act and new secs. 48A and 48B of the Code) ..... 29
7. Transmission property treated as fifteen-year property (sec. 1308 of the Act and sec. 168 of the Code) ..... 31
8. Amortization of atmospheric pollution control facilities (sec. 1309 of the Act and sec. 169 of the Code) ..... 31
9. Modification to special rules for nuclear decommissioning costs (sec. 1310 of the Act and sec. 468A of the Code) ..... 32
10. Five-year carryback of net operating losses for certain electric utility companies (sec. 1311 of the Act and sec. 172 of the Code) ..... 35
11. Modification of credit for producing fuel from a non-conventional source (secs. 1321 and 1322 of the Act and sec. 29 and new sec. 45K of the Code) ..... 37
12. Temporary expensing for equipment used in the refining of liquid fuels (sec. 1323 of the Act and new sec. 179C of the Code) ..... 39
13. Allow pass through to owners of deduction for capital costs incurred by small refiner cooperative in complying with environmental protection agency sulfur regulations (sec. 1324 of the Act and sec. 179B of the Code) ..... 41
14. Natural gas distribution lines treated as fifteen-year property (sec. 1325 of the Act and sec. 168 of the Code) ..... 43
15. Natural gas gathering lines treated as seven-year property (sec. 1326 of the Act and sec. 168 of the Code) ..... 43
16. Arbitrage rules not to apply to prepayments for natural gas (sec. 1327 of the Act and sec. 148 of the Code) ..... 44
17. Determination of small refiner exception to oil depletion deduction (sec. 1328 of the Act and sec. 613A of the Code) ..... 48

Page

18. Amortization of geological and geophysical expenditures (sec. 1329 of the Act and sec. 167 of the Code) ..... 49
19. Credit for energy efficient commercial buildings deduction (sec. 1331 of the Act and new sec. 179D of the Code) ..... 52
20. Credit for energy efficient new homes (sec. 1332 of the Act and new sec. 45L of the Code) ..... 54
21. Credit for certain nonbusiness energy property (sec. 1333 of the Act and new sec. 25C of the Code) ..... 55
22. Credit for energy efficient appliances (sec. 1334 of the Act and new sec. 45M of the Code) ..... 57
23. Credit for residential energy efficient property (sec. 1335 of the Act and new sec. 25D of the Code) ..... 58
24. Credit for business installation of qualified fuel cells and stationary microturbine power plants (sec. 1336 of the Act and sec. 48 of the Code) ..... 59
25. Business solar investment tax credit (sec. 1337 of the Act and sec. 48 of the Code) ... 61
26. Alternative technology vehicle credits (secs. 1341 and 1348 of the Act, sec. 179A of the Code, and new sec. 30B of the Code) ..... 62
27. Credit for installation of alternative fuel refueling property (sec. 1342 of the Act and new sec. 30C of the Code) ..... 68
28. Diesel-water fuel emulsion (sec. 1343 of the Act and sec. 4081 of the Code) ..... 69
29. Extend excise tax provisions and income tax credit for biodiesel and create similar incentives for renewable diesel (secs. 1344 and 1346 of the Act, and secs. 40A, 6426 and 6427 of the Code) ..... 71
30. Small agri-biodiesel producer credit (sec. 1345 of the Act and sec. 40A of the Code) 73
31. Modifications to small ethanol producer credit (sec. 1347 of the Act and sec. 40 of the Code) ..... 75
32. Modify research credit for research relating to energy (sec. 1351 of the Act and sec. 41 of the Code) ..... 75
33. National Academy of Sciences study (sec. 1352 of the Act) ..... 77
34. Recycling study (sec. 1353 of the Act) ..... 78
35. Oil Spill Liability Trust Fund (sec. 1361 of the Act and sec. 4611 of the Code) ..... 78

Page

36. Leaking Underground Storage Tank Trust Fund (sec. 1362 of the Act and secs. 4041, 4081(d), 4082, 9508, and new sec. 6430 of the Code) ..... 79
37. Modify recapture of section 197 amortization (sec. 1363 of the Act and sec. 1245 of the Code) ..... 80
38. Clarification of tire excise tax (sec. 1364 of the Act and sec. 4072(e) of the Code) .... 81

**Part Six: Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (Public Law 109–59)** ..... 83

TITLE XI—HIGHWAY REAUTHORIZATION AND EXCISE TAX SIMPLIFICATION ..... 83

I. TRUST FUND REAUTHORIZATION ..... 83

A. Extension of Highway Trust Fund and Aquatic Resources Trust Fund Expenditure Authority and Related Taxes (secs. 11101 and 11102 of the Act, and secs. 4041, 4051, 4071, 4081, 4221, 4481, 4482, 4483, 6412, 9503, and 9504 of the Code) ..... 83

II. EXCISE TAX REFORM AND SIMPLIFICATION ..... 89

A. Highway Excise Taxes ..... 89

1. Modify gas guzzler tax (sec. 11111 of the Act and sec. 4064 of the Code) ..... 89
2. Exclusion for tractors weighing 19,500 pounds or less from excise tax on heavy trucks and trailers (sec. 11112 of the Act and sec. 4051 of the Code) ..... 90
3. Volumetric excise tax credit for alternative fuels (sec. 11113 of the Act and secs. 4041, 4101, 6426, and 6427 of the Code) .. 91

B. Aquatic Excise Taxes ..... 93

1. Eliminate Aquatic Resources Trust Fund and transform Sport Fish Restoration Account (sec. 11115 of the Act and secs. 9503 and 9504 of the Code) ..... 93
2. Repeal of harbor maintenance tax on exports (sec. 11116 of the Act and sec. 4461 of the Code) ..... 95
3. Cap on excise tax on certain fishing equipment (sec. 11117 of the Act and sec. 4161 of the Code) ..... 96

C. Aerial Excise Taxes ..... 97

Page

1. Clarification of excise tax exemptions for agricultural aerial applicators and exemption for fixed-wing aircraft engaged in forestry operations (sec. 11121 of the Act and secs. 4261 and 6420 of the Code) ..... 97
2. Modify the definition of rural airport (sec. 11122 of the Act and sec. 4261 of the Code) ..... 99
3. Exempt from ticket taxes transportation provided by seaplanes (sec. 11123 of the Act and secs. 4261 and 4083 of the Code) 99
4. Exempt certain sightseeing flights from taxes on air transportation (sec. 11124 of the Act and sec. 4281 of the Code) ..... 100

D. Taxes Relating to Alcohol ..... 101

1. Repeal special occupational taxes on producers and marketers of alcoholic beverages (sec. 11125 of the Act and secs. 5081, 5091, 5111, 5112, 5113, 5117, 5121, 5122, 5123, 5125, 5131, 5132, 5141, 5147, 5148, and 5276 of the Code) ..... 101
2. Provide an income tax credit for cost of carrying tax-paid distilled spirits in wholesale inventories and in control State bailment warehouses (sec. 11126 of the Act and new sec. 5011 of the Code) ..... 103
3. Quarterly excise tax filing for small alcohol excise taxpayers (sec. 11127 of the Act and sec. 5061 of the Code) ..... 105

E. Sport Excise Taxes ..... 106

1. Custom gunsmiths (sec. 11131 of the Act and sec. 4182 of the Code) ..... 106

III. MISCELLANEOUS PROVISIONS ..... 108

A. Motor Fuel Tax Enforcement Advisory Commission (sec. 11141 of the Act) ..... 108

B. National Surface Transportation Infrastructure Financing Commission (sec. 11142 of the Act) 109

C. Tax-Exempt Financing of Highway Projects and Rail-Truck Transfer Facilities (sec. 11143 of the Act and sec. 142 of the Code) ..... 111

D. Treasury Study of Highway Fuels Used by Trucks for Non-Transportation Purposes (sec. 11144 of the Act) ..... 112

Page

E. Diesel Fuel Tax Evasion Report (sec. 11145 of the Act) ..... 113

F. Tax Treatment of State Ownership of Railroad Real Estate Investment Trust (sec. 11146 of the Act and secs. 103, 115, 336, and 337 of the Code) ..... 114

G. Leaking Underground Storage Tank Trust Fund (sec. 11147 of the Act) ..... 116

IV. PREVENTING FUEL FRAUD ..... 118

A. Treatment of Kerosene for Use in Aviation (sec. 11161 of the Act and secs. 4041, 4081, 4082, 6427, 9502, and 9503 of the Code) ..... 118

B. Repeal of Ultimate Vendor Refund Claims with Respect to Farming (sec. 11162 of the Act and sec. 6427(l) of the Code) ..... 120

C. Refunds of Excise Taxes on Exempt Sales of Taxable Fuel by Credit Card (sec. 11163 of the Act and secs. 6206, 6416, 6427, and 6675 of the Code) ..... 122

D. Reregistration in Event of Change in Ownership (sec. 11164 of the Act and secs. 4101, 6719, 7232, and 7272 of the Code) ..... 124

E. Reconciliation of On-Loaded Cargo to Entered Cargo (sec. 11165 of the Act and sec. 343 of the Trade Act of 2002) ..... 125

F. Treatment of Deep-Draft Vessels (sec. 11166 of the Act and secs. 4081 and 4101 of the Code) ..... 126

G. Impose Assessable Penalty on Dealers of Adulterated Fuel (sec. 11167 of the Act and new sec. 6720A of the Code) ..... 127

V. FUELS-RELATED TECHNICAL CORRECTIONS ..... 129

A. Fuels-Related Technical Corrections to American Jobs Creation Act of 2004 ("AJCA") ..... 129

1. Volumetric ethanol excise tax credit (sec. 11151(a) of the Act, sec. 301 of AJCA, and sec. 6427 of the Code) ..... 129
2. Aviation fuel (sec. 11151(b) of the Act, sec. 853 of AJCA, and sec. 4081 of the Code) .. 129

Page

B. Fuels-Related Technical Corrections to Transportation Equity Act for the 21st Century ("TEA 21") ..... 129

1. Coastal Wetlands sub-account (sec. 11151(c) and (d) of the Act, sec. 9005 of TEA 21, and sec. 9504 of the Code) ..... 129

C. Correction to the Energy Tax Incentives Act of 2005 ..... 130

1. Erroneous reference to highway reauthorization bill (sec. 11151(f) of the Act and sec. 38 of the Code) ..... 130

**Part Seven: Katrina Emergency Tax Relief Act of 2005 (Public Law 109–73)** ..... 131

Definition of "Hurricane Katrina Disaster Area" and "Core Disaster Area" (sec. 2 of the Act) ..... 131

TITLE I—SPECIAL RULES FOR USE OF RETIREMENT FUNDS FOR RELIEF RELATING TO HURRICANE KATRINA ..... 132

A. Tax-Favored Withdrawals from Retirement Plans for Relief Relating to Hurricane Katrina (sec. 101 of the Act) ..... 132

B. Recontributions of Withdrawals for Home Purchases Cancelled Due to Hurricane Katrina (sec. 102 of the Act) ..... 134

C. Loans from Qualified Plans for Relief Relating to Hurricane Katrina (sec. 103 of the Act) ..... 135

D. Plan Amendments in Connection with Hurricane Katrina (sec. 104 of the Act) ..... 136

TITLE II—EMPLOYMENT RELIEF ..... 138

A. Work Opportunity Tax Credit for Hurricane Katrina Employees (sec. 201 of the Act) ..... 138

B. Employee Retention Credit for Employers Affected by Hurricane Katrina (sec. 202 of the Act) ..... 140

TITLE III—CHARITABLE GIVING INCENTIVES ..... 142

A. Temporary Suspension of Limitations on Charitable Contributions (sec. 301 of the Act) ..... 142

Page

B. Additional Personal Exemption for Housing Hurricane Katrina Displaced Individuals (sec. 302 of the Act) ..... 146

C. Increase in Standard Mileage Rate for Charitable Use of Vehicles (sec. 303 of the Act) ..... 147

D. Mileage Reimbursements to Charitable Volunteers Excluded from Gross Income (sec. 304 of the Act) ..... 149

E. Charitable Deduction for Contributions of Food Inventory (sec. 305 of the Act and sec. 170 of the Code) ..... 151

F. Charitable Deduction for Contributions of Book Inventories to Public Schools (sec. 306 of the Act and sec. 170 of the Code) ..... 152

TITLE IV—ADDITIONAL TAX RELIEF PROVISIONS ..... 154

A. Exclusion for Certain Cancellations of Indebtedness by Reason of Hurricane Katrina (sec. 401 of the Act) ..... 154

B. Suspension of Certain Limitations on Personal Casualty Losses (sec. 402 of the Act) ..... 155

C. Required Exercise of IRS Administrative Authority (sec. 403 of the Act) ..... 156

D. Special Rules for Mortgage Revenue Bonds (sec. 404 of the Act) ..... 158

E. Extension of Replacement Period for Nonrecognition of Gain (sec. 405 of the Act) ..... 159

F. Special Look-Back Rule for Determining Earned Income Credit and Refundable Child Credit (sec. 406 of the Act) ..... 160

G. Secretarial Authority to Make Adjustments Regarding Taxpayer and Dependency Status for Taxpayers Affected by Hurricane Katrina (sec. 407 of the Act) ..... 161

**Part Eight: Sportfishing and Recreational Boating Safety Amendments Act of 2005 (Public Law 109–74)** ..... 163

A. Sportfishing and Recreational Boating Safety Amendments Act of 2005 (secs. 101 and 301 of the Act and sec. 9504 of the Code) ..... 163

Page

**Part Nine: Gulf Opportunity Zone Act of 2005 (Public Law 109–135)** ..... 165

TITLE I—ESTABLISHMENT OF GULF OPPORTUNITY ZONE ..... 165

A. Tax Benefits for Gulf Opportunity Zone ..... 165

1. Definitions of "Gulf Opportunity Zone," "Rita GO Zone," "Wilma GO Zone," and other definitions (sec. 101 of the Act and new sec. 1400M of the Code) ..... 165
2. Tax-exempt bond financing for the Gulf Opportunity Zone (sec. 101 of the Act and new sec. 1400N(a) of the Code) ..... 166
3. Advance refunding of certain tax-exempt bonds (sec. 101 of the Act and new sec. 1400N(b) of the Code) ..... 171
4. Increase the low-income housing credit cap and make other modifications (sec. 101 of the Act and new sec. 1400N(c) of the Code) ..... 173
5. Additional first-year depreciation for Gulf Opportunity Zone property (sec. 101 of the Act and new sec. 1400N(d) of the Code) ..... 177
6. Increase in expensing for Gulf Opportunity Zone property (sec. 101 of the Act and new sec. 1400N(e) of the Code) ..... 179
7. Expensing for certain demolition and clean-up costs (sec. 101 of the Act and new sec. 1400N(f) of the Code) ..... 181
8. Extension and expansion of expensing for environmental remediation costs (sec. 101 of the Act and new sec. 1400N(g) of the Code) ..... 182
9. Increase in rehabilitation tax credit with respect to certain buildings located in the Gulf Opportunity Zone (sec. 101 of the Act and new sec. 1400N(h) of the Code) ... 184
10. Increased expensing for reforestation expenditures of small timber producers (sec. 101 of the Act and new sec. 1400N(i)(1) of the Code) ..... 184
11. Five-year NOL carryback of certain timber losses (sec. 101 of the Act and new sec. 1400N(i)(2) of the Code) ..... 186
12. Special rule for Gulf Opportunity Zone public utility casualty losses (sec. 101 of the Act and new sec. 1400N(j) of the Code) ..... 188

Page

13. Five-year NOL carryback for certain amounts related to Hurricane Katrina or the Gulf Opportunity Zone (sec. 101 of the Act and new sec. 1400N(k) of the Code) ..... 189
14. Gulf tax credit bonds (sec. 101 of the Act and new sec. 1400N(l) of the Code) ..... 192
15. Additional allocation of new markets tax credit for investments that serve the Gulf Opportunity Zone (sec. 101 of the Act and new sec. 1400N(m) of the Code) ..... 194
16. Representations regarding income eligibility for purposes of qualified residential rental project requirements (sec. 101 of the Act and new sec. 1400N(n) of the Code) ..... 196
17. Treatment of public utility property disaster losses (sec. 101 of the Act and new sec. 1400N(o) of the Code) ..... 197
18. Tax benefits not available with respect to certain property (sec. 101 of the Act and new sec. 1400N of the Code) ..... 198
19. Expansion of Hope Scholarship and Lifetime Learning Credit for students in the Gulf Opportunity Zone (sec. 102 of the Act and new sec. 1400O of the Code) ..... 199
20. Housing relief for individuals affected by Hurricane Katrina (sec. 103 of the Act and new sec. 1400P of the Code) ..... 203
21. Special rules for mortgage revenue bonds (sec. 104 of the Act and sec. 404 of the Katrina Emergency Tax Relief Act of 2005) ..... 204
22. Treasury authority to grant bonus depreciation placed-in-service date relief (sec. 105 of the Act and sec. 168(k) of the Code) ..... 205

TITLE II—TAX BENEFITS RELATED TO HURRICANES RITA AND WILMA ..... 208

A. Special Rules for Use of Retirement Funds (sec. 201 of the Act and new sec. 1400Q of the Code) ..... 208

1. Tax-favored withdrawals from retirement plans relating to Hurricanes Rita and Wilma ..... 208
2. Recontributions of withdrawals for home purchases cancelled due to Hurricanes Rita and Wilma ..... 210
3. Loans from qualified plans to individuals sustaining an economic loss due to Hurricane Rita or Wilma ..... 212

Page

4. Plan amendments relating to Hurricane Rita and Hurricane Wilma relief ..... 214

B. Employee Retention Credit for Employers Affected by Hurricanes Katrina, Rita, and Wilma (sec. 201 of the Act and new sec. 1400R of the Code) ..... 215

C. Temporary Suspension of Limitations on Charitable Contributions (sec. 201 of the Act and new sec. 1400S(a) of the Code) ..... 216

D. Suspension of Certain Limitations on Personal Casualty Losses (sec. 201 of the Act and new section 1400S(b) of the Code) ..... 220

E. Required Exercise of IRS Administrative Authority (sec. 201 of the Act and new sec. 1400S(c) of the Code) ..... 221

F. Special Look-Back Rule for Determining Earned Income Credit and Refundable Child Credit (sec. 201 of the Act and new sec. 1400S(d) of the Code) ..... 223

G. Secretarial Authority to Make Adjustments Regarding Taxpayer and Dependency Status (sec. 201 of the Act and new sec. 1400S(e) of the Code) ..... 225

H. Special Rules for Mortgage Revenue Bonds (sec. 201 of the Act and new sec. 1400T of the Code) ..... 226

TITLE III—OTHER PROVISIONS ..... 229

A. Gulf Coast Recovery Bonds (sec. 301 of the Act) ..... 229

B. Election to Treat Combat Pay as Earned Income for Purposes of the Earned Income Credit (sec. 302 of the Act and sec. 32 of the Code) 229

C. Modifications of Suspension of Interest and Penalties Where Internal Revenue Service Fails to Contact Taxpayer (sec. 303 of the Act and sec. 6404(g) of the Code) ..... 230

D. Authority for Undercover Operations (sec. 304 of the Act and sec. 7608 of the Code) ..... 231

E. Disclosures of Certain Tax Return Information 232

Page

1. Disclosure of tax information to facilitate combined employment tax reporting (sec. 305 of the Act and sec. 6103(d)(5) of the Code) ..... 232
2. Disclosure of return information regarding terrorist activities (sec. 305 of the Act and sec. 6103(i)(3) and (i)(7) of the Code) ..... 233
3. Disclosure of return information to carry out income contingent repayment of student loans (sec. 305 of the Act and sec. 6103(l)(13) of the Code) ..... 236

TITLE IV—TAX TECHNICAL CORRECTIONS ..... 237

A. Technical Corrections (secs. 401–412 of the Act) ..... 237

B. Other Corrections (sec. 413 of the Act) ..... 255

**Part Ten: Extension of Parity in the Application of Certain Limits to Mental Health Benefits (Public Law 109–151)** ..... 257

A. Extension of Parity in the Application of Certain Limits to Mental Health Benefits (sec. 1 of the Act and sec. 9812(f)(3) of the Code, sec. 712(f) of ERISA and sec. 2705(f) of the PHSA) ..... 257

**Part Eleven: Tax Increase Prevention and Reconciliation Act of 2005 (Public Law 109–222)** ..... 259

TITLE I—EXTENSION AND MODIFICATION OF CERTAIN PROVISIONS ..... 259

A. Extension of Increased Expensing for Small Business (sec. 101 of the Act and sec. 179 of the Code) ..... 259

B. Reduced Rates for Capital Gains and Dividends of Individuals (sec. 102 of the Act and sec. 1(h) of the Code) ..... 260

C. Controlled Foreign Corporations ..... 264

1. Subpart F exception for active financing income (sec. 103(a) of the Act and secs. 953 and 954 of the Code) ..... 264
2. Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company income rules (sec. 103(b) of the Act and sec. 954(c) of the Code) ..... 267

Page

TITLE II—OTHER PROVISONS ..... 269

A. Taxation of Certain Settlement Funds (sec. 201 of the Act and sec. 468B of the Code) ..... 269

B. Modifications to Rules Relating to Taxation of Distributions of Stock and Securities of a Controlled Corporation (secs. 202 and 507 of the Act and sec. 355 of the Code) ..... 270

C. Qualified Veterans' Mortgage Bonds (sec. 203 of the Act and sec. 143 of the Code) ..... 274

D. Capital Gains Treatment for Certain Self-Created Musical Works (sec. 204 of the Act and sec. 1221 of the Code) ..... 276

E. Decrease Minimum Vessel Tonnage Limit to 6,000 Deadweight Tons (sec. 205 of the Act and sec. 1355 of the Code) ..... 277

F. Modification of Special Arbitrage Rule for Certain Funds (sec. 206 of the Act) ..... 279

G. Amortization of Expenses Incurred in Creating or Acquiring Music or Music Copyrights (sec. 207 of the Act and sec. 167(g) of the Code) ..... 280

H. Capital Expenditure Limitation for Qualified Small Issue Bonds (sec. 208 of the Act and sec. 144 of the Code) ..... 282

I. Modification of Treatment of Loans to Qualified Continuing Care Facilities (sec. 209 of the Act and sec. 7872(g) of the Code) ..... 283

TITLE III—ALTERNATIVE MINIMUM TAX RELIEF ..... 286

A. Extend and Increase Alternative Minimum Tax Exemption Amount for Individuals (sec. 301 of the Act and sec. 55 of the Code) ..... 286

B. Allowance of Nonrefundable Personal Credits Against Regular and Alternative Minimum Tax Liability (sec. 302 of the Act and sec. 26 of the Code) ..... 287

TITLE IV—CORPORATE ESTIMATED TAX PROVISIONS . 289

A. Modifications to Corporate Estimated Tax Payments (sec. 401 of the Act) ..... 289

TITLE V—REVENUE OFFSET PROVISIONS ..... 290

Page

A. Application of Earnings Stripping Rules to Partners Which are Corporations (sec. 501 of the Act and sec. 163 of the Code) ..... 290

B. Amend Information Reporting Requirements to Include Interest on Tax-Exempt Bonds (sec. 502 of the Act and sec. 6049 of the Code) ..... 291

C. Amortization of Geological and Geophysical Expenditures (sec. 503 of the Act and sec. 167(h) of the Code) ..... 292

D. Application of Foreign Investment in Real Property Tax Act ("FIRPTA") to Regulated Investment Companies ("RICs") (sec. 504 of the Act and sec. 897(h)(4) of the Code) ..... 293

E. Treatment of REIT and RIC Distributions Attributable to FIRPTA Gains (secs. 505 and 506 of the Act and secs. 897, 852, and 871 of the Code) ..... 296

F. 355 Distributions Involving Disqualified Investment Companies (sec. 507 of the Act and sec. 355 of the Code) ..... 301

G. Impose Loan and Redemption Requirements on Pooled Financing Bonds (sec. 508 of the Act and sec. 149 of the Code) ..... 302

H. Partial Payments Required with Submissions of Offers-in-Compromise (sec. 509 of the Act and sec. 7122 of the Code) ..... 305

I. Increase in Age of Minor Children Whose Unearned Income is Taxed as if Parent's Income (sec. 510 of the Act and sec. 1(g) of the Code) . 306

J. Imposition of Withholding on Certain Payments Made by Government Entities (sec. 511 of the Act and sec. 3402 of the Code) ..... 309

K. Eliminate Income Limitations on Roth IRA Conversions (sec. 512 of the Act and sec. 408A of the Code) ..... 311

L. Repeal of FSC/ETI Binding Contract Relief (sec. 513 of the Act) ..... 314

M. Modification of Wage Limit for Purposes of Domestic Production Activities Deduction (sec. 514 of the Act and sec. 199 of the Code) ..... 316

Page

N. Modification of Exclusion for Citizens Living Abroad (sec. 515 of the Act and sec. 911 of the Code) ..... 317

O. Tax Involvement of Accommodation Parties in Tax Shelter Transactions (sec. 516 of the Act and secs. 6011, 6033, 6652, and new sec. 4965 of the Code) ..... 320

**Part Twelve: Heroes Earned Retirement Opportunities Act (Public Law 109–227)** ..... 327

A. Combat Zone Compensation Taken into Account for Purposes of Determining Limitation and Deductibility of Contributions to Individual Retirement Plans (sec. 2 of the Act and sec. 219(f) of the Code) ..... 327

**Part Thirteen: Pension Protection Act of 2006 (Public Law 109–280)** ..... 329

TITLE I—REFORM OF FUNDING RULES FOR SINGLE-EMPLOYER DEFINED BENEFIT PENSION PLANS ..... 329

A. Minimum Funding Standards for Single-Employer Defined Benefit Pension Plans (secs. 101, 102, 107, 111, 112, 114, and 301 of the Act, secs. 302–308 of ERISA, and sec. 412 and new sec. 430 of the Code) ..... 329

B. Benefit Limitations Under Single-Employer Defined Benefit Pension Plans (secs. 103 and 113 of the Act, new secs. 101(j) and 206(g) of ERISA, and new sec. 436 of the Code) ..... 350

C. Special Rules for Multiple-Employer Plans of Certain Cooperatives (sec. 104 of the Act) ..... 357

D. Temporary Relief for Certain PBGC Settlement Plans (sec. 105 of the Act) ..... 359

E. Special Rules for Plans of Certain Government Contractors (sec. 106 of the Act) ..... 360

F. Modification of Transition Rule to Pension Funding Requirements for Interstate Bus Company (sec. 115 of the Act, and sec. 769(c) of the Retirement Protection Act, as added by sec. 1508 of the Taxpayer Relief Act of 1997) ..... 361

Page

G. Restrictions on Funding of Nonqualified Deferred Compensation Plans by Employers Maintaining Underfunded or Terminated Single-Employer Plans (sec. 116 of the Act and sec. 409A of the Code) ..... 363

TITLE II—FUNDING RULES FOR MULTIEMPLOYER DEFINED BENEFIT PLANS ..... 366

A. Funding Rules for Multiemployer Defined Benefit Plans (secs. 201 and 211 of the Act, new sec. 304 of ERISA, and new sec. 431 of the Code) ..... 366

B. Additional Funding Rules for Multiemployer Plans in Endangered or Critical Status (secs. 202, 212 and 221(c) of the Act, new sec. 305 of ERISA, and new sec. 432 of the Code) ..... 372

C. Measures to Forestall Insolvency of Multiemployer Plans (secs. 203 and 213 of the Act, sec. 4245 of ERISA, and sec. 418E of the Code) ..... 386

D. Withdrawal Liability Reforms (sec. 204 of the Act, and secs. 4203, 4205, 4210, 4219, 4221 and 4225 of ERISA) ..... 387

1. Update of rules relating to limitation on withdrawal liability in certain cases ..... 387
2. Withdrawal liability continues if work contracted out ..... 388
3. Application of forgiveness rule to plans primarily covering employees in building and construction ..... 389
4. Procedures applicable to disputes involving withdrawal liability ..... 390

E. Prohibition on Retaliation against Employers Exercising their Rights to Petition the Federal Government (sec. 205 of the Act and sec. 510 of ERISA) ..... 392

F. Special Rule for Certain Benefits Funded Under an Agreement Approved by the PBGC (sec. 206 of the Act) ..... 393

G. Exception from Excise Tax for Certain Multiemployer Pension Plans (sec. 214 of the Act) .. 393

H. Sunset of Multiemployer Plan Funding Provisions (sec. 221 of the Act) ..... 394

TITLE III—INTEREST RATE ASSUMPTIONS ..... 395

Page

A. Extension of Replacement of 30-Year Treasury Rates (sec. 301 of the Act, secs. 302 and 4006 of ERISA, and sec. 412 of the Code) ..... 395

B. Interest Rate Assumption for Determination of Lump-Sum Distributions (sec. 302 of the Act, sec. 205(g) of ERISA, and sec. 417(e) of the Code) ..... 395

C. Interest Rate Assumption for Applying Benefit Limitations to Lump-Sum Distributions (sec. 303 of the Act and sec. 415(b) of the Code) ..... 397

TITLE IV—PBGC GUARANTEE AND RELATED PROVISIONS ..... 399

A. PBGC Premiums (secs. 301 and 401 of the Act and sec. 4006 of ERISA) ..... 399

B. Special Funding Rules for Plans Maintained by Commercial Airlines (sec. 402 of the Act) ... 402

C. Limitations on PBGC Guarantee of Shutdown and Other Benefits (sec. 403 of the Act and sec. 4022 of ERISA) ..... 409

D. Rules Relating to Bankruptcy of the Employer (sec. 404 of the Act and secs. 4022 and 4044 of ERISA) ..... 410

E. PBGC Variable Rate Premiums for Small Plans (sec. 405 of the Act and sec. 4006 of ERISA) ..... 412

F. Authorization for PBGC to Pay Interest on Premium Overpayment Refunds (sec. 406 of the Act and sec. 4007(b) of ERISA) ..... 413

G. Rules for Substantial Owner Benefits in Terminated Plans (sec. 407 of the Act and secs. 4021, 4022, 4043, and 4044 of ERISA) ..... 413

H. Acceleration of PBGC Computation of Benefits Attributable to Recoveries from Employers (sec. 408 of the Act and secs. 4022(c), 4044, and 4062(c) of ERISA) ..... 414

I. Treatment of Certain Plans Where There is a Cessation or Change in Membership of a Controlled Group (sec. 409 of the Act and sec. 4041(b) of ERISA) ..... 415

J. Missing Participants (sec. 410 of the Act and sec. 4050 of ERISA) ..... 417

Page

K. Director of the PBGC (sec. 411 of the Act and secs. 4002 and 4003 of ERISA) ..... 418

L. Inclusion of Information in the PBGC Annual Report (sec. 412 of the Act and sec. 4008 of ERISA) ..... 419

TITLE V—DISCLOSURE ..... 420

A. Defined Benefit Plan Funding Notice (sec. 501 of the Act and secs. 101(f) and 4011 of ERISA) ..... 420

B. Access to Multiemployer Pension Plan Information (sec. 502 of the Act, secs. 101, 204(h), and 502(c) of ERISA, and sec. 4980F of the Code) ..... 423

C. Additional Annual Reporting Requirements and Electronic Display of Annual Report Information (secs. 503–504 of the Act and secs. 103 and 104 of ERISA) ..... 425

D. Section 4010 Filings with the PBGC (sec. 505 of the Act and sec. 4010 of ERISA) ..... 428

E. Disclosure of Plan Termination Information to Plan Participants (sec. 506 of the Act and secs. 4041 and 4042 of ERISA) ..... 429

F. Notice of Freedom to Divest Employer Securities (sec. 507 of the Act and new sec. 101(m) and sec. 502(c) of ERISA) ..... 431

G. Periodic Pension Benefit Statements (sec. 508 of the Act and secs. 105(a) and 502(c) of ERISA) ..... 433

H. Notice to Participants or Beneficiaries of Blackout Periods (sec. 509 of the Act and sec. 101(i) of ERISA) ..... 435

TITLE VI—INVESTMENT ADVICE, PROHIBITED TRANSACTIONS, AND FIDUCIARY RULES ..... 439

A. Prohibited Transaction Exemption for Provision of Investment Advice (sec. 601 of the Act, sec. 408 of ERISA, and sec. 4975 of the Code) 439

B. Prohibited Transaction Rules Relating to Financial Investments (sec. 611 of the Act, secs. 408, 412(a), 502(i) and new sec. 3(42) of ERISA, and sec. 4975 of the Code) ..... 445

Page

1. Exemption for block trading ..... 445
2. Bonding relief ..... 446
3. Exemption for electronic communication network ..... 446
4. Exemption for service providers ..... 447
5. Relief for foreign exchange transactions ..... 448
6. Definition of plan asset vehicle ..... 449
7. Exemption for cross trading ..... 450

C. Correction Period for Certain Transactions Involving Securities and Commodities (sec. 612 of the Act, sec. 408 of ERISA, and sec. 4975 of the Code) ..... 452

D. Inapplicability of Relief from Fiduciary Liability During Suspension of Ability of Participant or Beneficiary to Direct Investments (sec. 621 of the Act and sec. 404(c) of ERISA) . 454

E. Increase in Maximum Bond Amount (sec. 622 of the Act and sec. 412(a) of ERISA) ..... 457

F. Increase in Penalties for Coercive Interference with Exercise of ERISA Rights (sec. 623 of the Act and sec. 511 of ERISA) ..... 457

G. Treatment of Investment of Assets By Plan Where Participant Fails to Exercise Investment Election (sec. 624 of the Act and sec. 404(c) of ERISA) ..... 458

H. Clarification of Fiduciary Rules (sec. 625 of the Act) ..... 459

TITLE VII—BENEFIT ACCRUAL STANDARDS (SECS. 701–702 OF THE ACT, SECS. 203, 204 AND 205 OF ERISA, SECS. 411 AND 417 OF THE CODE, AND SEC. 4(I) OF ADEA) ..... 460

TITLE VIII—PENSION RELATED REVENUE PROVISIONS ..... 469

A. Deduction Limitations ..... 469

1. Increase in deduction limits applicable to single-employer and multiemployer defined benefit pension plans (secs. 801 and 802 of the Act and sec. 404 of the Code) ... 469
2. Updating deduction rules for combination of plans (sec. 803 of the Act and secs. 404(a)(7) and 4972 of the Code) ..... 472

B. Certain Pension Provisions Made Permanent ... 473

Page

1. Permanency of EGTRRA pension and IRA provisions (sec. 811 of the Act and Title X of EGTRRA) ..... 473
2. Saver's credit made permanent (sec. 812 of the Act and sec. 25B of the Code) ..... 475

C. Improvements in Portability, Distribution, and Contribution Rules ..... 477

1. Purchase of permissive service credit (sec. 821 of the Act, and secs. 403(b)(13), 415(n)(3), and 457(e)(17) of the Code) ..... 477
2. Rollover of after-tax amounts in annuity contracts (sec. 822 of the Act and sec. 402(c)(2) of the Code) ..... 479
3. Application of minimum distribution rules to governmental plans (sec. 823 of the Act) ..... 480
4. Allow direct rollovers from retirement plans to Roth IRAs (sec. 824 of the Act and sec. 408A(e) of the Code) ..... 481
5. Eligibility for participation in eligible deferred compensation plans (sec. 825 of the Act and sec. 457 of the Code) ..... 483
6. Modifications of rules governing hardships and unforeseen financial emergencies (sec. 826 of the Act) ..... 483
7. Treatment of distributions to individuals called to active duty for at least 179 days (sec. 827 of the Act and sec. 72(t) of the Code) ..... 484
8. Inapplicability of 10-percent additional tax on early distributions of pension plans of public safety employees (sec. 828 of the Act and sec. 72(t) of the Code) ..... 485
9. Rollovers by nonspouse beneficiaries (sec. 829 of the Act and sec. 402 of the Code) ... 486
10. Direct deposit of tax refunds in an IRA (sec. 830 of the Act) ..... 487
11. Additional IRA contributions for certain employees (sec. 831 of the Act and secs. 25B and 219 of the Code) ..... 488
12. Special rule for computing high-three average compensation for benefit limitation purposes (sec. 832 of the Act and sec. 415(b)(3) of the Code) ..... 489
13. Inflation indexing of gross income limitations on certain retirement savings incentives (sec. 833 of the Act and secs. 25A and 219 of the Code) ..... 489

D. Health and Medical Benefits ..... 492

Page

1. Ability to use excess pension assets for future retiree health benefits and collectively bargained retiree health benefits (sec. 841 of the Act and sec. 420 of the Code) ..... 492
2. Transfer of excess pension assets to multiemployer health plans (sec. 842 of the Act and sec. 420 of the Code) ..... 496
3. Allowance of reserve for medical benefits of plans sponsored by bona fide associations (sec. 843 of the Act and sec. 419A of the Code) ..... 498
4. Tax treatment of combined annuity or life insurance contracts with a long-term care insurance feature (sec. 844 of the Act, secs. 72, 1035 and 7702B and new sec. 6050U of the Code) ..... 499
5. Permit tax-free distributions from governmental retirement plans for premiums for health and long-term care insurance for public safety officers (sec. 845 of the Act and sec. 402 of the Code) ..... 504

E. United States Tax Court Modernization ..... 505

1. Judges of the Tax Court (secs. 851, 852 and 853 of the Act and secs. 7447, 7448 and 7472 of the Code) ..... 505
2. Special trial judges of the Tax Court (secs. 854 and 856 of the Act, and sec. 7448 and new sec. 7443C of the Code) ..... 506
3. Consolidate review of collection due process cases in the Tax Court (sec. 855 of the Act and sec. 6330(d) of the Code) ..... 507
4. Extend authority for special trial judges to hear and decide certain employment status cases (sec. 857 of the Act and sec. 7443A of the Code) ..... 508
5. Confirmation of Tax Court authority to apply equitable recoupment (sec. 858 of the Act and sec. 6214(b) of the Code) ..... 508
6. Tax Court filing fee (sec. 859 of the Act and sec. 7451 of the Code) ..... 509
7. Use of practitioner fee (sec. 860 of the Act and sec. 7475(b) of the Code) ..... 510

F. Other Provisions ..... 510

1. Extension to all governmental plans of moratorium on application of certain nondiscrimination rules (sec. 861 of the Act, sec. 1505 of the Taxpayer Relief Act of 1997, and secs. 401(a) and 401(k) of the Code) ..... 510

Page

2. Eliminate aggregate limit for usage of excess funds from black lung disability trusts to pay for retiree health (sec. 862 of the Act and secs. 501(c)(21) and 9705 of the Code) ..... 511
3. Tax treatment of death benefits from company-owned life insurance ("COLI") (sec. 863 of the Act and new secs. 101(j) and 6039I of the Code) ..... 512
4. Treatment of test room supervisors and proctors who assist in the administration of college entrance and placement exams (sec. 864 of the Act and sec. 530 of the Revenue Reconciliation Act of 1978) ..... 517
5. Rule for church plans which self-annuitize (sec. 865 of the Act and sec. 401(a)(9) of the Code) ..... 518
6. Exemption for income from leveraged real estate held by church plans (sec. 866 of the Act and sec. 514(c)(9) of the Code) ..... 518
7. Church plan rule for benefit limitations (sec. 867 of the Act and sec. 415(b) of the Code) ..... 519
8. Gratuitous transfers for the benefit of employees (sec. 868 of the Act and sec. 664 of the Code) ..... 520

TITLE IX: INCREASE IN PENSION PLAN DIVERSIFICATION AND PARTICIPATION AND OTHER PENSION PROVISIONS ..... 521

A. Defined Contribution Plans Required to Provide Employees with Freedom to Invest Their Plan Assets (sec. 901 of the Act, new sec. 401(a)(35) of the Code, and new sec. 204(j) of ERISA) ..... 521

B. Increase Participation Through Automatic Enrollment Arrangements (sec. 902 of the Act, secs. 404(c) and 514 of ERISA, and secs. 401(k), 401(m), 414 and 4979 of the Code) ..... 527

C. Treatment of Eligible Combined Defined Benefit Plans and Qualified Cash or Deferred Arrangements (sec. 903 of the Act, new sec. 414(x) of the Code, and new sec. 210(e) of ERISA) ..... 534

D. Faster Vesting of Employer Nonelective Contributions (sec. 904 of the Act, sec. 203 of ERISA, and sec. 411 of the Code) ..... 542

Page

E. Distributions During Working Retirement (sec. 905 of the Act, sec. 3(2) of ERISA, and new sec. 401(a)(35) of the Code) ..... 543

F. Treatment of Plans Maintained by Indian Tribes (sec. 906 of the Act, sec. 414(d) of the Code, and sec. 3(32) of ERISA) ..... 544

TITLE X—SPOUSAL PENSION PROTECTION ..... 546

A. Regulations on Time and Order of Issuance of Domestic Relations Orders (sec. 1001 of the Act) ..... 546

B. Benefits Under the Railroad Retirement System for Former Spouses (secs. 1002 and 1003 of the Act, and secs. 2 and 5 of the Railroad Retirement Act of 1974) ..... 547

C. Requirement for Additional Survivor Annuity Option (sec. 1004 of the Act, sec. 417 of the Code, and sec. 205 of ERISA) ..... 548

TITLE XI—ADMINISTRATIVE PROVISIONS ..... 551

A. Updating of Employee Plans Compliance Resolution System (sec. 1101 of the Act) ..... 551

B. Notice and Consent Period Regarding Distributions (sec. 1102 of the Act, sec. 417(a) of the Code, and sec. 205(c) of ERISA) ..... 552

C. Pension Plan Reporting Simplification (sec. 1103 of the Act) ..... 554

D. Voluntary Early Retirement Incentive and Employment Retention Plans Maintained by Local Educational Agencies and Other Entities (sec. 1104 of the Act, secs. 457(e)(11) and 457(f) of the Code, sec. 3(2)(B) of ERISA, and sec. 4(l)(1) of the ADEA) ..... 555

E. No Reduction in Unemployment Compensation as a Result of Pension Rollovers (sec. 1105 of the Act and sec. 3304(a)(15) of the Code) .... 557

F. Revocation of Election Relating to Treatment as Multiemployer Plan (sec. 1106 of the Act, sec. 3(37) of ERISA, and sec. 414(f) of the Code) ..... 558

G. Provisions Relating to Plan Amendments (sec. 1107 of the Act) ..... 559

Page

TITLE XII—PROVISIONS RELATING TO EXEMPT ORGANIZATIONS ..... 561

A. Charitable Giving Incentives ..... 561

1. Tax-free distributions from individual retirement plans for charitable purposes (sec. 1201 of the Act and secs. 408, 6034, 6104, and 6652 of the Code) ..... 561
2. Extension of modification of charitable deduction for contributions of food inventory (sec. 1202 of the Act and sec. 170 of the Code) ..... 567
3. Basis adjustment to stock of S corporation contributing property (sec. 1203 of the Act and sec. 1367 of the Code) ..... 569
4. Extension of modification of charitable deduction for contributions of book inventory (sec. 1204 of the Act and sec. 170 of the Code) ..... 569
5. Modification of tax treatment of certain payments under existing arrangements to controlling exempt organizations (sec. 1205 of the Act and secs. 512 and 6033 of the Code) ..... 571
6. Encouragement of contributions of capital gain real property made for conservation purposes (sec. 1206 of the Act and sec. 170 of the Code) ..... 572
7. Excise taxes exemption for blood collector organizations (sec. 1207 of the Act and secs. 4041, 4221, 4253, 4483, 6416, and 7701 of the Code) ..... 575

B. Reforming Exempt Organizations ..... 580

1. Require reporting on certain acquisitions of interests in insurance contracts in which certain exempt organizations hold an interest; require Treasury Study (sec. 1211 of the Act and new sec. 6050V of the Code) ..... 580
2. Increase in penalty excise taxes relating to public charities, social welfare organizations, and private foundations (sec. 1212 of the Act and secs. 4941, 4942, 4943, 4944, 4945, and 4958 of the Code) .. 583
3. Reform of charitable contributions of certain easements in registered historic districts and reduction of deduction for portion of qualified conservation contribution attributable to rehabilitation credit (sec. 1213 of the Act and sec. 170 of the Code) . 587

Page

4. Charitable contributions of taxidermy property (sec. 1214 of the Act and sec. 170 of the Code) ..... 592
5. Recapture of tax benefit for charitable contributions of exempt use property not used for an exempt use (sec. 1215 of the Act and secs. 170, 6050L, and new sec. 6720B of the Code) ..... 594
6. Limitation of deduction for charitable contributions of clothing and household items (sec. 1216 of the Act and sec. 170 of the Code) ..... 597
7. Modification of recordkeeping requirements for certain charitable contributions (sec. 1217 of the Act and sec. 170 of the Code) . 600
8. Contributions of fractional interests in tangible personal property (sec. 1218 of the Act and secs. 170, 2055, and 2522 of the Code) ..... 601
9. Provisions relating to substantial and gross overstatements of valuations (sec. 1219 of the Act and secs. 170, 6662, 6664, 6696 and new sec. 6695A of the Code) ..... 603
10. Additional exemption standards for credit counseling organizations (sec. 1220 of the Act and secs. 501 and 513 of the Code) .... 607
11. Expansion of the base of tax on private foundation net investment income (sec. 1221 of the Act and sec. 4940 of the Code) ..... 615
12. Definition of convention or association of churches (sec. 1222 of the Act and sec. 7701 of the Code) ..... 619
13. Notification requirement for entities not currently required to file an annual information return (sec. 1223 of the Act and secs. 6033, 6652, and 7428 of the Code) ... 619
14. Disclosure to State officials relating to exempt organizations (sec. 1224 of the Act and secs. 6103, 6104, 7213, 7213A, and 7431 of the Code) ..... 621
15. Public disclosure relating to unrelated business income tax returns (sec. 1225 of the Act and sec. 6104 of the Code) ..... 623
16. Treasury study on donor advised funds and supporting organizations (sec. 1226 of the Act) ..... 624
17. Improved accountability of donor advised funds (secs. 1231–1235 of the Act and secs. 170, 508, 2055, 2522, 4943, 4958, 6033, and new secs. 4966 and 4967 of the Code) ..... 628

Page

18. Improved accountability of supporting organizations (secs. 1241–1245 of the Act and secs. 509, 4942, 4943, 4945, 4958, and 6033 of the Code) ..... 644

TITLE XIII—OTHER PROVISIONS ..... 656

A. Exception from Local Furnishing Requirements for Certain Alaska Hydroelectric Projects (sec. 1303 of the Act) ..... 656

B. Extend Certain Tax Rules for Qualified Tuition Programs (sec. 1304 of the Act and sec. 529 of the Code) ..... 657

**Part Fourteen: Tax Relief and Health Care Act of 2006 (Public Law 109–432)** ..... 661

I. DIVISION A—EXTENSION AND EXPANSION OF CERTAIN TAX PROVISIONS AND OTHER PROVISIONS ..... 661

TITLE I—EXTENSION AND MODIFICATION OF CERTAIN PROVISIONS ..... 661

1. Above-the-line deduction for higher education expenses (sec. 101 of the Act and sec. 222 of the Code) ..... 661
2. Extension and modification of the new markets tax credit (sec. 102 of the Act and sec. 45D of the Code) ..... 662
3. Deduction of state and local general sales taxes (sec. 103 of the Act and sec. 164 of the Code) ..... 664
4. Extension and modification of the research credit (sec. 104 of the Act and sec. 41 of the Code) ..... 665
5. Work opportunity tax credit and welfare-to-work tax credit (sec. 105 of the Act and secs. 51 and 51A of the Code) ..... 670
6. Extend election to treat combat pay as earned income for purposes of the earned income credit (sec. 106 of the Act and sec. 32 of the Code) ..... 674
7. Extension and modification of qualified zone academy bonds (sec. 107 of the Act and sec. 1397E of the Code) ..... 675
8. Above-the-line deduction for certain expenses of elementary and secondary school teachers (sec. 108 of the Act and sec. 62 of the Code) ..... 678
9. Extension and expansion to petroleum products of expensing for environmental remediation costs (sec. 109 of the Act and sec. 198 of the Code) ..... 679

Page

10. Tax incentives for investment in the District of Columbia (sec. 110 of the Act and secs. 1400, 1400A, 1400B, and 1400C of the Code) ..... 681
11. Indian employment tax credit (sec. 111 of the Act and sec. 45A of the Code) ..... 683
12. Accelerated depreciation for business property on Indian reservations (sec. 112 of the Act and sec. 168 of the Code) ..... 685
13. Fifteen-year straight-line cost recovery for qualified leasehold improvements and qualified restaurant property (sec. 113 of the Act and sec. 168 of the Code) ..... 686
14. Suspend limitation on rate of rum excise tax cover over to Puerto Rico and Virgin Islands (sec. 114 of the Act and sec. 7652 of the Code) ..... 687
15. Parity in the application of certain limits to mental health benefits (sec. 115 of the Act and sec. 9812(f)(3) of the Code, sec. 712(f) of ERISA, and sec. 2705(f) of the PHSA) ..... 688
16. Expand charitable contribution allowed for scientific property used for research and expand and extend the charitable contribution allowed computer technology and equipment (sec. 116 of the Act and sec. 170 of the Code) ..... 689
17. Availability of Archer medical savings accounts (sec. 117 of the Act and sec. 220 of the Code) ..... 691
18. Taxable income limit on percentage depletion for oil and natural gas produced from marginal properties (sec. 118 of the Act and sec. 613A of the Code) ..... 693
19. Economic development credit for American Samoa (sec. 119 of the Act) ..... 694
20. Extension of placed-in-service deadline for certain Gulf Opportunity Zone property (sec. 120 of the Act and sec. 1400N of the Code) ..... 696
21. Authority for undercover operations (sec. 121 of the Act and sec. 7608 of the Code) . 699
22. Disclosures of certain tax return information (sec. 122 of the Act and sec. 6103 of the Code) ..... 700
23. Special rule for elections under expired provisions (sec. 123 of the Act) ..... 704

TITLE II—ENERGY TAX PROVISIONS ..... 705

Page

1. Extension of placed-in-service date for tax credit for electricity produced at wind, closed-loop biomass, open-loop biomass, geothermal energy, small irrigation power, landfill gas, trash combustion, or qualified hydropower facilities (sec. 201 of the Act and sec. 45 of the Code) ..... 705
2. Extension and expansion of clean renewable energy bonds (sec. 202 of the Act and sec. 54 of the Code) ..... 712
3. Modification of advanced coal credit with respect to subbituminous coal (sec. 203 of the Act and sec. 48A of the Code) ..... 714
4. Extension of energy efficient commercial buildings deduction (sec. 204 of the Act and sec. 179D of the Code) ..... 715
5. Extension of energy efficient new homes credit (sec. 205 of the Act and sec. 45L of the Code) ..... 717
6. Extension of credit for residential energy efficient property (sec. 206 of the Act and sec. 25D of the Code) ..... 718
7. Extension of business solar and fuel cell energy credit (sec. 207 of the Act and sec. 48 of the Code) ..... 719
8. Special rule for qualified methanol and ethanol fuel produced from coal (sec. 208 of the Act and sec. 4041 of the Code) ..... 720
9. Special depreciation allowance for cellulosic biomass ethanol plant property (sec. 209 of the Act and new sec. 168(l) of the Code) ..... 721
10. Expenditures permitted from the Leaking Underground Storage Tank Trust Fund (sec. 210 of the Act and sec. 9508 of the Code) ..... 723
11. Modification of credit for fuel from a nonconventional source (sec. 211 of the Act and sec. 45K of the Code) ..... 726

TITLE III—HEALTH SAVINGS ACCOUNTS ..... 728

1. Provisions relating to health savings accounts (sec. 301–307 of the Act and sec. 223 of the Code) ..... 728

TITLE IV—OTHER TAX PROVISIONS ..... 738

1. Deduction allowable with respect to income attributable to domestic production activities in Puerto Rico (sec. 401 of the Act and sec. 199 of the Code) ..... 738

Page

2. Alternative minimum tax credit relief for individuals; returns required for certain options (secs. 402 and 403 of the Act and secs. 53 and 6039 of the Code) ..... 739
3. Partial expensing for advanced mine safety equipment (sec. 404 of the Act and new sec. 179E of the Code) ..... 742
4. Mine rescue team training credit (sec. 405 of the Act and new sec. 45N of the Code) . 743
5. Whistleblower reforms (sec. 406 of the Act and sec. 7623 of the Code) ..... 744
6. Frivolous tax submissions (sec. 407 of the Act and sec. 6702 of the Code) ..... 746
7. Addition of meningococcal and human papillomavirus vaccines to the list of taxable vaccines (sec. 408 of the Act and sec. 4132 of the Code) ..... 747
8. Make permanent the tax treatment of certain settlement funds (sec. 409 of the Act and sec. 468B of the Code) ..... 747
9. Make permanent the active business rules relating to taxation of distributions of stock and securities of a controlled corporation (sec. 410 of the Act and sec. 355 of the Code) ..... 748
10. Make permanent the modifications to qualified veterans' mortgage bonds (sec. 411 of the Act and sec. 143 of the Code) ... 750
11. Make permanent the capital gains treatment for certain self-created musical works (sec. 412 of the Act and sec. 1221 of the Code) ..... 751
12. Make permanent the decrease in minimum vessel tonnage limit to 6,000 deadweight tons (sec. 413 of the Act and sec. 1355 of the Code) ..... 753
13. Make permanent the modification of special arbitrage rule for certain funds (sec. 414 of the Act) ..... 754
14. Great Lakes domestic shipping to not disqualify vessel from tonnage tax (sec. 415 of the Act and sec. 1355 of the Code) ..... 755
15. Expansion of the qualified mortgage bond program (sec. 416 of the Act and sec. 143 of the Code) ..... 758
16. Exclusion of gain on sale of a principal residence by certain employees of the intelligence community (sec. 417 of the Act and sec. 121 of the Code) ..... 760
17. Sale of property to comply with conflict-of interest requirements (sec. 418 of the Act and sec. 1043 of the Code) ..... 761

Page

18. Establish deduction for private mortgage insurance (sec. 419 of the Act and sec. 163 of the Code) ..... 762
19. Modification of refunds for kerosene used in aviation (sec. 420 of the Act and sec. 6427 of the Code) ..... 763
20. Regional income tax agencies treated as States for purposes of confidentiality and disclosure requirements (sec. 421 of the Act and sec. 6103 of the Code) ..... 766
21. Semi-generic wine names (sec. 422 of the Act and sec. 5388 of the Code) ..... 767
22. Railroad track maintenance credit (sec. 423 of the Act and sec. 45G of the Code) .. 768
23. Modify tax on unrelated business taxable income of charitable remainder trusts (sec. 424 of the Act and sec. 664 of the Code) ..... 770
24. Make permanent the special rule regarding treatment of loans to qualified continuing care facilities (sec. 425 of the Act and sec. 7872(h) of the Code) ..... 771
25. Tax technical corrections (sec. 426 of the Act) ..... 773

II. DIVISION C—OTHER PROVISIONS ..... 775

TITLE II—SURFACE MINING CONTROL AND RECLAMATION ACT AMENDMENTS OF 2006 ..... 775

1. Coal Industry Retiree Health Benefit Act .. 775

TITLE IV—OTHER PROVISIONS ..... 778

1. Clarification of prohibition of delivery sales of tobacco products (sec. 401 of the Act and sec. 5761 of the Code) ..... 778
2. Exclusion of 25 percent of capital gain for certain sales of mineral and oil leases for conservation purposes (sec. 403 of the Act) ..... 779
3. Tax court review of requests for equitable relief from joint and several liability (sec. 408 of the Act and sec. 6015 of the Code) . 781

**Part Fifteen: Fallen Firefighters Assistance Tax Clarification Act of 2006 (Public Law 109–445)** ..... 784

A. Payments by Certain Charitable Organizations for the Benefit of Firefighters Who Died as a Result of the Esperanza Fire Treated as Exempt Payments (sec. 2 of the Act) ..... 784

Page

**Appendix: Estimated Budget Effects of Tax Legislation Enacted in the 109th Congress** ..... 785

## INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation in consultation with the staffs of the House Committee on Ways and Means and the Senate Committee on Finance, provides an explanation of tax legislation enacted in the 109th Congress. The explanation follows the chronological order of the tax legislation as signed into law.

For each provision, the document includes a description of present law, explanation of the provision, and effective date. Present law describes the law in effect immediately prior to enactment. It does not reflect changes to the law made by the provision or subsequent to the enactment of the provision. For many provisions, the reasons for change are also included. In some instances, provisions included in legislation enacted in the 109th Congress were not reported out of committee before enactment. For example, in some cases, the provisions enacted were included in bills that went directly to the House and Senate floors. As a result, the legislative history of such provisions does not include the reasons for change normally included in a committee report. In the case of such provisions, no reasons for change are included with the explanation of the provision in this document.

In some cases, there is no legislative history for enacted provisions. For such provisions, this document includes a description of present law, explanation of the provision, and effective date, as prepared by the staff of the Joint Committee on Taxation. In some cases, contemporaneous technical explanations of certain bills were prepared and published by the staff of the Joint Committee. In those cases, this document follows the technical explanations.

Part One of this document is an explanation of the provision relating to the acceleration of the income tax benefits for charitable cash contributions for the relief of victims of the Indian Ocean tsunami (Pub. L. No. 109–1).

Part Two is an explanation of the provision relating to the extension of the Leaking Underground Storage Tank Trust Fund financing rate (Pub. L. No. 109–6).

Part Three is an explanation of the provision relating to the tax treatment of certain disaster mitigation payments (Pub. L. No. 109–7).

Part Four is an explanation of the provisions of the Surface Transportation Extension Act of 2005, Parts I—VI (Pub. L. Nos. 109–14, 109–20, 109–35, 109–37, 109–40, and 109–42), relating extensions of the Surface Transportation Act.

Part Five is an explanation of the energy tax policy incentive provisions of the Energy Policy Act of 2005 (Pub. L. No. 109–58)

[1] This document may be cited as follows: Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 109th Congress (JCS–1–07), January 17, 2007.

relating to electricity infrastructure, domestic fossil fuel security, conservation and energy efficiency, and alternative motor vehicles and fuels incentives.

Part Six is an explanation of the provisions of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for All Users (Pub. L. No. 109–59) relating to highway trust fund reauthorization and excise tax reform and simplification.

Part Seven is an explanation of the provisions of the Katrina Emergency Tax Relief Act of 2005 (Pub. L. No. 109–73) relating to special rules for use of retirement funds, employment relief, charitable giving incentives, and additional tax relief provisions relating to Hurricane Katrina.

Part Eight is an explanation of the provision of the Sportfishing and Recreational Boating Safety Amendments Act of 2005 (Pub. L. No. 109–74) relating to preserving law existing prior to the Sportfishing Act.

Part Nine is an explanation of the provisions of the Gulf Opportunity Zone Act of 2005 (Pub. L. No. 109–135) relating to establishment of the Gulf Opportunity Zone, tax benefits related to Hurricanes Rita and Wilma, other tax provisions, and tax technical corrections.

Part Ten is an explanation of the provision relating to the extension of parity in the application of certain limits to mental health benefits (Pub. L. No. 109–151).

Part Eleven is an explanation of the provisions of the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109–222) relating to the extension and modification of certain tax provisions, alternative minimum tax relief, corporate estimated tax provisions, and revenue offset provisions.

Part Twelve is an explanation of the provision of the heroes earned retirement opportunities act (Pub. L. No. 109–227) relating to taking into account combat zone compensation for purposes of determining the limitations and deductibility of contributions to individual retirement plans.

Part Thirteen is an explanation of the provisions of the Pension Protection Act of 2005 (Pub. L. No. 109–280) relating to the reform of funding rules for single-employer defined benefit pension plans, funding rules for multiemployer pension plans, the Pension Benefit Guarantee Corporation, disclosure, investment advice, prohibited transactions, and fiduciary rules, benefit accrual standards, pension related revenue provisions, increase in pension plan diversification and participation, spousal pension protection, administrative provisions, tax exempt organizations, and other provisions.

Part Fourteen is an explanation of the provisions of the Tax Relief and Health Care Act of 2006 (Pub. L. No. 109–432) relating to the extension and expansion of certain tax provisions, energy tax provisions, health savings accounts, and other tax provisions.

Part Fifteen is an explanation of the provision of the Fallen Firefighters Assistance Tax Clarification Act of 2006 (Pub. L. No. 109–445) relating to charitable payments made on behalf of firefighters who died as the result of the October 2006 Esperanza Incident fire in southern California.

The Appendix provides the estimated budget effects of tax legislation enacted in the 109th Congress.

The first footnote in each part gives the legislative history of each of the Acts of the 109th Congress discussed.

## PART ONE: TSUNAMI RELIEF (PUBLIC LAW 109–1) [2]

### A. Acceleration of Income Tax Benefits for Charitable Cash Contributions for Relief of Indian Ocean Tsunami Victims (sec. 1 of the Act)

#### *Present Law*

In general, under present law, taxpayers may claim an income tax deduction for charitable contributions. The charitable deduction generally is available for the taxable year in which the contribution is made. For taxpayers whose taxable year is the calendar year, the tax benefit of a charitable contribution made in January often is not realized until the following calendar year when the tax return is filed.

#### *Explanation of Provision*

The provision permits taxpayers to treat charitable contributions of cash made in January 2005, for the purpose of relief of victims of the Indian Ocean tsunami, as contributions made on December 31, 2004. Thus, the effect of the provision is to give calendar-year taxpayers who make tsunami-related charitable contributions of cash in January 2005 the opportunity to accelerate the tax benefit. Under the provision, such taxpayers may realize the tax benefit of such contributions by taking a deduction on their 2004 tax return.

#### *Effective Date*

The provision is effective on the date of enactment (January 7, 2005).

[2] H.R. 241. The House passed the bill without objection on January 6, 2005. The Senate passed the bill by unanimous consent on January 6, 2005. The President signed the bill on January 7, 2005.

## PART TWO: EXTENSION OF LEAKING UNDERGROUND STORAGE TANK TRUST FUND FINANCING RATE (PUBLIC LAW 109–6)[3]

### A. Extension of Leaking Underground Storage Tank Trust Fund Financing Rate (sec. 1 of the Act)

#### *Present Law*

The Code imposes an excise tax, generally at a rate of 0.1 cents per gallon, on gasoline, diesel, kerosene, special motor fuels (other than liquefied petroleum gas and liquefied natural gas) and inland waterway fuels to finance the Leaking Underground Storage Tank Trust Fund. The tax expires on April 1, 2005.

#### *Explanation of Provision*

The provision extends the Leaking Underground Storage Tank Trust Fund financing rate until October 1, 2005.[4]

#### *Effective Date*

The provision is effective on the date of enactment (March 31, 2005).

[3] H.R. 1270. The House passed the bill on the suspension calendar on March 16, 2005. The Senate passed the bill by unanimous consent on March 17, 2005. The President signed the bill on March 31, 2005.

[4] The tax was subsequently extended through September 30, 2011. See Part Five, A.36.

## PART THREE: TAX TREATMENT OF CERTAIN DISASTER MITIGATION PAYMENTS (PUBLIC LAW 109–7)[5]

### A. Tax Treatment of Certain Disaster Mitigation Payments (sec. 1 of the Act and sec. 139 of the Code)

#### *Present Law*

Gross income includes all income from whatever source derived unless a specific exception applies.

Gross income does not include amounts received by individuals as qualified disaster relief payments under section 139. Qualified disaster relief payments include amounts paid to an individual: (1) to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster; (2) to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster; (3) by a person engaged in the furnishing or sale of transportation by reason of death or personal injuries as a result of a qualified disaster; or (4) by a Federal, State, or local government, or agency or instrumentality thereof, in connection with a qualified disaster in order to promote the general welfare.

In addition to providing grants in the aftermath of a natural disaster, pursuant to the Robert T. Stafford Disaster Relief and Emergency Assistance Act and the National Flood Insurance Act, the Federal Emergency Management Agency ("FEMA") of the Department of Homeland Security conducts disaster mitigation assistance programs to provide grants through State and local governments for businesses and individuals to mitigate potential damage from future natural disasters.

There is no specific exclusion from gross income for amounts received pursuant to FEMA mitigation grants. FEMA provides these grants to mitigate potential damage from future hazards. The existing statutory exclusion under present law for qualified disaster relief payments only applies to certain amounts received by individuals as a result of a disaster that has occurred.

If certain requirements are met, section 1033 of the Code provides that if property is compulsorily or involuntarily converted and replaced within a certain period (generally two years), there is deferral of gain recognized as a result of the conversion. In general, the basis in the replacement property is the same as the taxpayer's basis in the converted property (decreased by the amount of any

[5] H.R. 1134. The House passed the bill on the suspension calendar on March 14, 2005. The Senate passed the bill with an amendment by unanimous consent on April 13, 2005. The House agreed to the Senate amendment without objection on April 14, 2005. The President signed the bill on April 15, 2005.

loss or money received by the taxpayer and increased by the amount of any gain recognized on the conversion).

In the case of the sale or exchange of a principal residence, present law allows an exclusion of up to $250,000 ($500,000 in the case of a joint return) if the property was used as the taxpayer's principal residence for two or more years during the five-year period ending on the date of the sale or exchange.

### *Explanation of Provision*

The provision provides an exclusion from gross income for amounts received as qualified disaster mitigation payments. Qualified disaster mitigation payments are amounts paid to or for the benefit of property owners for hazard mitigation pursuant to the Robert T. Stafford Disaster Relief and Emergency Assistance Act or the National Flood Insurance Act (the "Acts"). In particular, the provision provides exclusions for payments received from FEMA's Flood Mitigation Assistance Program, Pre-Disaster Mitigation Program, and Hazard Mitigation Grant Program. The exclusion applies to payments made pursuant to the Acts as in effect on the date of enactment.

Amounts received for the sale or disposition of property for the purpose of hazard mitigation are not eligible for the income exclusion. However, the provision provides that if property is sold or disposed to implement hazard mitigation (pursuant to the Acts), such sale or disposition is treated as an involuntary conversion, as defined by section 1033 of the Code. Thus, if a taxpayer sells property through a FEMA disaster mitigation program and the taxpayer replaces the property within the period specified under present law in the case of an involuntary conversion (i.e., generally two years), instead of currently including the gain in gross income, the taxpayer's basis in the replacement property is the same as the taxpayer's basis in the converted property (decreased by the amount of any loss or money received by the taxpayer and increased by the amount of any gain recognized on the conversion).

The provision provides that the basis of properties improved for the purpose of hazard mitigation is not increased by amounts received under FEMA mitigation grants that are excluded from gross income. The provision provides that no additional deduction or credit is allowed with respect to amounts excluded from income under the provision. The provision also applies this denial of double benefit rule to amounts received as qualified disaster relief payments under present law section 139 of the Code.

### *Effective Date*

The provision is effective for amounts received and sales or dispositions before, on, or after the date of enactment (April 15, 2005).

## PART FOUR: SURFACE TRANSPORTATION EXTENSION ACT OF 2005, PARTS I–VI (PUBLIC LAWS 109–14,[6] 109–20[7] 109–35,[8] 109–37,[9] 109–40,[10] AND 109–42[11])

### A. Extensions of Surface Transportation Act

#### *Present Law*

***Expenditure authority***

Under prior law, the Internal Revenue Code (sec. 9503) authorized expenditures (subject to appropriations) to be made from the Highway Trust Fund generally through May 31, 2005, for purposes provided in specified authorizing legislation as in effect on the date of enactment of the most recent authorizing Act (the Surface Transportation Extension Act of 2004, Part V).

Under prior law, expenditures also were authorized from the Aquatic Resources Trust Fund through May 31, 2005.

Highway Trust Fund spending is limited by anti-deficit provisions internal to the Highway Trust Fund, the so-called "Harry Byrd rule". The rule requires the Treasury Department to determine, on a quarterly basis, the amount (if any) by which unfunded highway authorizations exceed projected net Highway Trust Fund tax receipts for the 24-month period beginning at the close of each fiscal year (sec. 9503(d)). Similar rules apply to unfunded Mass Transit Account authorizations. If unfunded authorizations exceed projected 24-month receipts, apportionments to the States for specified programs funded by the relevant Trust Fund Account are to be reduced proportionately. Because of the Harry Byrd rule, taxes dedicated to the Highway Trust Fund typically are scheduled to expire at least two years after current authorizing Acts.

The Surface Transportation Extension Act of 2003, created a temporary rule (through February 29, 2004) for purposes of the anti-deficit provisions of the Highway Trust Fund. For purposes of determining 24 months of projected revenues for the anti-deficit provisions, the Secretary of the Treasury is instructed to treat each expiring provision relating to appropriations and transfers to the Highway Trust Fund to have been extended through the end of the 24-month period and to assume that the rate of tax during such 24-

[6] H.R. 2566. The House passed the bill on the suspension calendar on May 25, 2005. The Senate passed the bill by unanimous consent on May 26, 2005. The President signed the bill on May 31, 2005.

[7] H.R. 3104. The House passed the bill without objection on June 30, 2005. The Senate passed the bill by unanimous consent on June 30, 2005. The President signed the bill on July 1, 2005.

[8] H.R. 3332. The House passed the bill without objection on July 19, 2005. The Senate passed the bill by unanimous consent on July 19, 2005. The President signed the bill on July 20, 2005.

[9] H.R. 3377. The House passed the bill without objection on July 21, 2005. The Senate passed the bill by unanimous consent on July 21, 2005. The President signed the bill on July 22, 2005.

[10] H.R. 3453. The House passed the bill without objection on July 27, 2005. The Senate passed the bill by unanimous consent on July 27, 2005. The President signed the bill on July 28, 2005.

[11] H.R. 3512. The House passed the bill without objection on July 29, 2005. The Senate passed the bill by unanimous consent on July 29, 2005. The President signed the bill on July 30, 2005.

month period remains at the same rate in effect on the date of enactment of the provision. The Surface Transportation Extension Act of 2004 extended this rule through April 30, 2004. The Surface Transportation Extension Act of 2004, Part II, extended this rule through June 30, 2004. The Surface Transportation Extension Act of 2004, Part III, extended this rule through July 31, 2004. The Surface Transportation Extension Act of 2004, Part IV, extended this rule through September 30, 2004. The Surface Transportation Extension Act of 2004, Part V, extended this rule through May 31, 2005.

***Heavy vehicle use tax***

The Code imposes an annual use tax imposed on highway vehicles having a taxable gross weight of 55,000 pounds or more (sec. 4481). The maximum rate for this tax is $550 per year, imposed on vehicles having a taxable gross weight over 75,000 pounds. The use tax is dedicated to the Highway Trust Fund and was to terminate on October 1, 2005. For a tax period that ends on September 30, 2005, the amount of the use tax will be determined by reducing the amount of tax due by 75 percent.

## *Explanation of Provision*

### *Surface Transportation Act of 2005 (sec. 9)*

*Expenditure authority*

The Act extends the authority to make expenditures (subject to appropriations) from the Highway Trust Fund through June 30, 2005. The Act also updates the Highway Trust Fund cross-references to authorizing legislation to include expenditure purposes in this Act as in effect on the date of enactment.

For purposes of the anti-deficit provisions of the Highway Trust Fund, the Act extends the temporary rule through June 30, 2005.

The Act extends the authority to make expenditures (subject to appropriations) from the Aquatics Resources Trust Fund through June 30, 2005. The Act also updates the Aquatics Resources Trust Fund cross-references to authorizing legislation to include expenditure purposes as in effect on the date of enactment of this Act.

*Heavy vehicle use tax*

The Act extends until October 1, 2006, the annual use tax on heavy vehicles and sets forth a special rule for the imposition of such tax when the taxable period ends on September 30, 2006. For a tax period that ends on September 30, 2006, the amount of the use tax will be determined by reducing the amount of tax due by 75 percent.

### *Surface Transportation Act of 2005, Part II (sec. 9)*

The Act extends the authority to make expenditures (subject to appropriations) from the Highway Trust Fund through July 19, 2005. The Act also updates the Highway Trust Fund cross-references to authorizing legislation to include expenditure purposes in this Act as in effect on the date of enactment.

For purposes of the anti-deficit provisions of the Highway Trust Fund, the Act extends the temporary rule through July 19, 2005.

The Act extends the authority to make expenditures (subject to appropriations) from the Aquatics Resources Trust Fund through July 19, 2005. The Act also updates the Aquatics Resources Trust Fund cross-references to authorizing legislation to include expenditure purposes as in effect on the date of enactment of this Act.

***Surface Transportation Act of 2005, Part III (sec. 9)***

The Act extends the authority to make expenditures (subject to appropriations) from the Highway Trust Fund through July 21, 2005. The Act also updates the Highway Trust Fund cross-references to authorizing legislation to include expenditure purposes in this Act as in effect on the date of enactment.

For purposes of the anti-deficit provisions of the Highway Trust Fund, the Act extends the temporary rule through July 21, 2005.

The Act extends the authority to make expenditures (subject to appropriations) from the Aquatics Resources Trust Fund through July 21, 2005. The Act also updates the Aquatics Resources Trust Fund cross-references to authorizing legislation to include expenditure purposes as in effect on the date of enactment of this Act.

***Surface Transportation Act of 2005, Part IV (sec. 9)***

The Act extends the authority to make expenditures (subject to appropriations) from the Highway Trust Fund through July 27, 2005. The Act also updates the Highway Trust Fund cross-references to authorizing legislation to include expenditure purposes in this Act as in effect on the date of enactment.

For purposes of the anti-deficit provisions of the Highway Trust Fund, the Act extends the temporary rule through July 27, 2005.

The Act extends the authority to make expenditures (subject to appropriations) from the Aquatics Resources Trust Fund through July 27, 2005. The Act also updates the Aquatics Resources Trust Fund cross-references to authorizing legislation to include expenditure purposes as in effect on the date of enactment of this Act.

***Surface Transportation Act of 2005, Part V (sec. 9)***

The Act extends the authority to make expenditures (subject to appropriations) from the Highway Trust Fund through July 30, 2005. The Act also updates the Highway Trust Fund cross-references to authorizing legislation to include expenditure purposes in this Act as in effect on the date of enactment.

For purposes of the anti-deficit provisions of the Highway Trust Fund, the Act extends the temporary rule through July 30, 2005.

The Act extends the authority to make expenditures (subject to appropriations) from the Aquatics Resources Trust Fund through July 30, 2005. The Act also updates the Aquatics Resources Trust Fund cross-references to authorizing legislation to include expenditure purposes as in effect on the date of enactment of this Act.

***Surface Transportation Act of 2005, Part VI (sec. 7)***

The Act extends the authority to make expenditures (subject to appropriations) from the Highway Trust Fund through August 14, 2005. The Act also updates the Highway Trust Fund cross-references to authorizing legislation to include expenditure purposes in this Act as in effect on the date of enactment.

For purposes of the anti-deficit provisions of the Highway Trust Fund, the Act extends the temporary rule through August 14, 2005.

The Act extends the authority to make expenditures (subject to appropriations) from the Aquatics Resources Trust Fund through August 14, 2005. The Act also updates the Aquatics Resources Trust Fund cross-references to authorizing legislation to include expenditure purposes as in effect on the date of enactment of this Act.

### *Effective Date*

The provisions are effective on the dates of enactment (in the case of Pub. L. No. 109–14, May 31, 2005; in the case of Part II, July 1, 2005; in the case of Part III, July 20, 2005; in the case of Part IV, July 22, 2005; in the case of Part V, July 28, 2005; and in the case of Part VI, July 30, 2005).

# PART FIVE: THE ENERGY POLICY ACT OF 2005 (PUBLIC LAW 109–58) [12]

## A. Energy Tax Policy Incentives

### 1. Extension and modification of renewable electricity production credit (secs. 1301 and 1302 of the Act and sec. 45 of the Code)

#### *Present Law*

***In general***

An income tax credit is allowed for the production of electricity from qualified facilities sold by the taxpayer to an unrelated person (sec. 45). Qualified facilities comprise wind energy facilities, closed-loop biomass facilities, open-loop biomass (including agricultural livestock waste nutrients) facilities, geothermal energy facilities, solar energy facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities. In addition, an income tax credit is allowed for the production of refined coal.

***Credit amounts and credit period***

*In general*

The base amount of the credit is 1.5 cents per kilowatt-hour (indexed for inflation) of electricity produced. The amount of the credit is 1.9 cents per kilowatt-hour for 2005. A taxpayer may claim credit for the 10-year period commencing with the date the qualified facility is placed in service. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits. The amount of credit a taxpayer may claim is phased out as the market price of electricity (or refined coal in the case of the refined coal production credit) exceeds certain threshold levels.

*Reduced credit amounts and credit periods*

In the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), geothermal energy facilities, solar energy facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities, the 10-year credit period

[12] H.R. 6. The House Committee on Ways and Means reported H.R. 1541 on April 18, 2005 (H.R. Rep. No. 109–45). The text of H.R. 1541 was added to H.R. 6 as title XIII. The House passed H.R. 6 on April 21, 2005. The Senate Committee on Finance ordered reported on June 16, 2005, a bill the text of which as modified was added as title XV to H.R. 6. The Senate passed H.R. 6 with an amendment on June 28, 2005. The conference report was filed on July 27, 2005 (H.R. Rep. No. 109–190) and was passed by the House on July 28, 2005, and the Senate on July 29, 2005. The President signed the bill on August 8, 2005. For a technical explanation of the bill prepared by the staff of the Joint Committee on Taxation, see Joint Committee on Taxation, *Description and Technical Explanation of the Conference Agreement of H.R. 6, Title XIII, the "Energy Tax Incentives Act of 2005"* (JCX–60–05), July 28, 2005. For references to the technical explanation, see 151 Cong. Rec. H 6953 (July 28, 2005) and 151 Cong. Rec. S 9117 (July 27, 2005).

is reduced to five years commencing on the date the facility is placed in service. In general, for eligible pre-existing facilities and other facilities placed in service prior to January 1, 2005, the credit period commences on January 1, 2005. In the case of a closed-loop biomass facility modified to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, the credit period begins no earlier than October 22, 2004.

In the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), small irrigation power facilities, landfill gas facilities, and trash combustion facilities, the otherwise allowable credit amount is 0.75 cent per kilowatt-hour, indexed for inflation measured after 1992 (currently 0.9 cents per kilowatt-hour for 2005).

*Credit applicable to refined coal*

The amount of the credit for refined coal is $4.375 per ton (also indexed for inflation after 1992 and equaling $5.481 per ton for 2005).

*Other limitations on credit claimants and credit amounts*

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

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

The credit for electricity produced from renewable sources is a component of the general business credit (sec. 38(b)(8)). Generally, the general business credit for any taxable year may not exceed the amount by which the taxpayer's net income tax exceeds the greater of the tentative minimum tax or so much of the net regular tax liability as exceeds $25,000. Excess credits may be carried back one year and forward up to 20 years.

A taxpayer's tentative minimum tax is treated as being zero for purposes of determining the tax liability limitation with respect to the section 45 credit for electricity produced from a facility (placed in service after October 22, 2004) during the first four years of production beginning on the date the facility is placed in service.

***Qualified facilities***

*Wind energy facility*

A wind energy facility is a facility that uses wind to produce electricity. To be a qualified facility, a wind energy facility must be placed in service after December 31, 1993, and before January 1, 2006.

*Closed-loop biomass facility*

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

To be a qualified facility, a closed-loop biomass facility must be placed in service after December 31, 1992, and before January 1, 2006. In the case of a facility using closed-loop biomass but also co-firing the closed-loop biomass with coal, other biomass, or coal and other biomass, a qualified facility must be originally placed in service and modified to co-fire the closed-loop biomass at any time before January 1, 2006.

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

An open-loop biomass facility is a facility using open-loop biomass to produce electricity. Open-loop biomass is defined as (1) any agricultural livestock waste nutrients, or (2) any solid, nonhazardous, cellulosic or lignin waste material which is segregated from other waste materials and which is derived from certain forest-related resources, solid wood waste materials, or agricultural sources. Eligible forest-related resources are mill residues, other than spent chemicals from pulp manufacturing, precommercial thinnings, slash, and brush. Solid wood waste materials include waste pallets, crates, dunnage, manufacturing and construction wood wastes (other than pressure-treated, chemically-treated, or painted wood wastes), and landscape or right-of-way tree trimmings. Agricultural sources include orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues. However, qualifying open-loop biomass does not include municipal solid waste (garbage), gas derived from biodegradation of solid waste, or paper that is commonly recycled. In addition, open-loop biomass does not include closed-loop biomass or any biomass burned in conjunction with fossil fuel (co-firing) beyond such fossil fuel required for start up and flame stabilization.

Agricultural livestock waste nutrients are defined as agricultural livestock manure and litter, including bedding material for the disposition of manure.

To be a qualified facility, an open-loop biomass facility must be placed in service after October 22, 2004 and before January 1, 2006, in the case of a facility using agricultural livestock waste nu-

trients and must be placed in service at any time prior to January 1, 2006 in the case of a facility using other open-loop biomass.

*Geothermal facility*

A geothermal facility is a facility that uses geothermal energy to produce electricity. Geothermal energy is energy derived from a geothermal deposit which is a geothermal reservoir consisting of natural heat which is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure). To be a qualified facility, a geothermal facility must be placed in service after October 22, 2004 and before January 1, 2006.

*Solar facility*

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

*Small irrigation facility*

A small irrigation power facility is a facility that generates electric power through an irrigation system canal or ditch without any dam or impoundment of water. The installed capacity of a qualified facility must be not less than 150 kilowatts but less than five megawatts. To be a qualified facility, a small irrigation facility must be originally placed in service after October 22, 2004 and before January 1, 2006.

*Landfill gas facility*

A landfill gas facility is a facility that uses landfill gas to produce electricity. Landfill gas is defined as methane gas derived from the biodegradation of municipal solid waste. To be a qualified facility, a landfill gas facility must be placed in service after October 22, 2004 and before January 1, 2006.

*Trash combustion facility*

Trash combustion facilities are facilities that burn municipal solid waste (garbage) to produce steam to drive a turbine for the production of electricity. To be a qualified facility, a trash combustion facility must be placed in service after October 22, 2004 and before January 1, 2006.

*Refined coal facility*

A qualifying refined coal facility is a facility producing refined coal that is placed in service after October 22, 2004 and before January 1, 2009. Refined coal is a qualifying liquid, gaseous, or solid synthetic fuel produced from coal (including lignite) or high-carbon fly ash, including such fuel used as a feedstock. A qualifying fuel is a fuel that when burned emits 20 percent less nitrogen oxides and either SO2 or mercury than the burning of feedstock coal or comparable coal predominantly available in the marketplace as of January 1, 2003, and if the fuel sells at prices at least 50 percent greater than the prices of the feedstock coal or comparable coal. In addition, to be qualified refined coal the fuel must be sold by the taxpayer with the reasonable expectation that it will be used for the primary purpose of producing steam.

### *Summary of credit rate and credit period by facility type*

**Table 1.—Summary of Section 45 Credit for Electricity Produced from Certain Renewable Resources and Refined Coal**

| Electricity produced from renewable resources | Credit amount for 2005 (cents per kilowatt-hour; dollars per ton) | Credit period (years from placed-in-service date)[1] |
|---|---|---|
| Wind | 1.9 | 10 |
| Closed-loop biomass | 1.9 | 10 |
| Open-loop biomass (including agricultural livestock waste nutrient facilities) | 0.9 | 5 |
| Geothermal | 1.9 | 5 |
| Solar | 1.9 | 5 |
| Small irrigation power | 0.9 | 5 |
| Municipal solid waste (including landfill gas facilities and trash combustion facilities) | 0.9 | 5 |
| Refined Coal | 5.481 | 10 |

[1] For eligible pre-existing facilities and other facilities placed in service prior to January 1, 2005, the credit period commences on January 1, 2005. In the case of certain co-firing closed-loop facilities, the credit period begins no earlier than October 22, 2004.

### *Taxation of cooperatives and their patrons*

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception—the cooperative may exclude from its taxable income distributions of patronage dividends. Generally, cooperatives that are subject to the cooperative tax rules of subchapter T of the Code[13] are permitted a deduction for patronage dividends from their taxable income only to the extent of net income that is derived from transactions with patrons who are members of the cooperative.[14] The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative. Present law does not permit cooperatives to pass any portion of the income tax credit for electricity production through to their patrons.

## *Explanation of Provision*[15]

### *Extension of placed-in-service date for qualifying facilities*

The provision extends the placed-in-service date by two years (through December 31, 2007) for the following qualifying facilities: wind facilities; closed-loop biomass facilities (including a facility co-firing the closed-loop biomass with coal, other biomass, or coal and other biomass); open-loop biomass facilities; geothermal facilities; small irrigation power facilities; landfill gas facilities; and trash

[13] Sec. 1381, et seq.
[14] Sec. 1382.
[15] The provision was subsequently modified in Division A, section 201 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

combustion facilities. The provision does not alter the terminating placed-in-service date for solar facilities (December 31, 2005) or refined coal facilities (December 31, 2008).

***New qualifying energy resources***

*In general*

The provision adds two new qualifying energy resources: hydropower and Indian coal.

*Hydropower*

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

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

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

In the case of electricity generated from a qualifying hydropower facility, the taxpayer may claim a credit equal to one-half the otherwise allowable amount.

*Indian coal*

The provision adds Indian coal as a new energy source. The taxpayer may claim a credit for sales of coal to an unrelated third party from a qualified facility for the seven-year period beginning on January 1, 2006, and ending after December 31, 2012. The value of the credit is $1.50 per ton for the first four years of the seven-year period and $2.00 per ton for the last three years of the seven-year period. The credit amounts are indexed for inflation. A qualified Indian coal facility is a facility that produces coal from re-

serves that on June 14, 2005, were owned by a Federally recognized tribe of Indians or were held in trust by the United States for a tribe or its members.

***Equalization of credit period for all qualifying renewable resources***

The provision extends the credit period from five years to 10 years for electricity produced from qualifying open-loop biomass facilities (including agricultural livestock waste nutrient facilities), geothermal facilities, solar facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities placed in service after the date of enactment. The provision also provides that for electricity produced from qualified hydropower the credit period is 10 years. The provision provides a seven-year credit period for Indian coal facilities, as explained above.

***Clarification of units added to pre-existing trash combustion facilities***

The provision clarifies that a qualifying trash combustion facility includes a new unit, placed in service after October 22, 2004, that increases electricity production capacity at an existing trash combustion facility. A new unit generally would include a new burner/boiler and turbine. The new unit may share certain common equipment, such as trash handling equipment, with other pre-existing units at the same facility. Electricity produced at a new unit of an existing facility qualifies for the production credit only to the extent of the increased amount of electricity produced at the entire facility.

***Taxation of cooperatives and their patrons***

The provision allows eligible cooperatives to elect to pass any portion of the credit through to their patrons. An eligible cooperative is defined as a cooperative organization that is owned more than 50 percent by agricultural producers or entities owned by agricultural producers.

Under the provision, the credit may be apportioned among patrons eligible to share in patronage dividends on the basis of the quantity or value of business done with or for such patrons for the taxable year. The election must be made on a timely filed return for the taxable year, and once made, is irrevocable for such taxable year.

The amount of the credit apportioned to patrons is not included in the organization's credit for the taxable year of the organization. The amount of the credit apportioned to a patron is included in the first taxable year of such patron ending on or after the last day of the payment period (as defined in section 1382(d)) for the taxable year of the organization or, if earlier, for the taxable year of the patron ending on or after the date on which the patron receives notice from the cooperative of the apportionment. If the amount of the credit for any taxable year is less than the amount of the credit shown on the cooperative's return for such taxable year, an amount equal to the excess of the reduction in the credit over the amount not apportioned to patrons for the taxable year is treated as an increase in the cooperative's tax. The increase is not treated as tax

imposed for purposes of determining the amount of any tax credit under Chapter 1 of the Code.

### *Effective Date*

The provision generally is effective on the date of enactment (August 8, 2005). With respect to the taxation of cooperatives and their patrons, the provision applies to taxable years ending after the date of enactment.

## 2. Clean renewable energy bonds (sec. 1303 of the Act and new sec. 54 of the Code)

### *Present law*

#### *Tax-exempt bonds*

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Subject to certain restrictions, activities that can be financed with these tax-exempt bonds include electric power facilities (i.e., generation, transmission, distribution, and retailing).

Generally, interest on State or local government bonds to finance activities of private persons ("private activity bonds") is taxable unless a specific exception is contained in the Code. The term "private person" generally includes the Federal Government and all other individuals and entities other than States or local governments. The Code includes exceptions permitting States or local governments to act as conduits providing tax-exempt financing for certain private activities. In most cases, the aggregate volume of these tax-exempt private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. For calendar year 2005, the State volume cap is the greater of $80 per resident or $239 million. The Code imposes several additional restrictions on tax-exempt private activity bonds that do not apply to bonds for governmental activities.

The tax exemption for State and local bonds also does not apply to any arbitrage bond.[16] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.[17] In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal government.

An issuer must file with the IRS certain information in order for a bond issue to be tax-exempt.[18] Generally, this information return

[16] Secs. 103(a) and (b)(2).
[17] Sec. 148.
[18] Sec. 149(e).

is required to be filed no later the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

### *Qualified zone academy bonds*

As an alternative to traditional tax-exempt bonds, States and local governments may issue "qualified zone academy bonds."[19] "Qualified zone academy bonds" are defined as any bond issued by a State or local government if, among other requirements, (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" 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.

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. 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 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 alternative minimum tax liability. 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.

There is an annual limitation of $400 million on the amount of qualified zone academy bonds that may be issued 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.

### *Tax credits for production of electricity from renewable sources*

An income tax credit is allowed for the production of electricity from qualified facilities sold by the taxpayer to an unrelated person.[20] The base amount of the credit is 1.5 cents per kilowatt-hour (indexed for inflation) of electricity produced. The amount of the

[19] Sec. 1397E.
[20] Sec. 45.

credit is 1.9 cents per kilowatt-hour for 2005. A taxpayer may claim a credit for the 10-year period commencing with the date the qualified facility is placed in service. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits. The amount of credit a taxpayer may claim is phased out as the market price of electricity (or refined coal in the case of or refined coal production credit) exceeds certain threshold levels.

Qualified facilities comprise wind energy facilities, closed-loop biomass facilities, open-loop biomass (including agricultural livestock waste nutrients) facilities, geothermal energy facilities, solar energy facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities. In addition, an income tax credit is allowed for the production of refined coal.

For purposes of the credit, qualified facilities must be placed in service by certain dates. However, with the exception of qualifying refined coal facilities, in no event may qualifying facilities be placed in service after December 31, 2005.

### *Explanation of Provision*[21]

The provision creates a new category of tax credit bonds: Clean Renewable Energy Bonds ("CREBs"). CREBs are defined as any bond issued by a qualified issuer if, in addition to the requirements discussed below, 95 percent or more of the proceeds of such bonds are used to finance capital expenditures incurred by qualified borrowers for qualified projects. Qualified projects are any qualified facilities within the meaning of section 45 (without regard to the placed-in-service date requirements of that section), other than Indian coal production facilities.

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

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

[21] The provision was subsequently extended in Division A, section 202 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

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

Under the provision, CREBs are subject to the arbitrage requirements of section 148 that apply to traditional tax-exempt bonds. Principles under section 148 and the regulations thereunder shall apply for purposes of determining the yield restriction and arbitrage rebate requirements applicable to CREBs. For example, for arbitrage purposes, the yield on an issue of CREBs 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 CREBs is not treated as interest, although such credit amount is treated as interest income to the taxpayer.

In addition, to qualify as CREBs, the qualified issuer must reasonably expect to and actually spend 95 percent or more of the proceeds of such bonds on qualified projects within the five-year period that begins on the date of issuance. To the extent less than 95 percent of the proceeds are used to finance qualified projects during the five-year spending period, bonds will continue to qualify as CREBs 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 provided in Treasury regulations under section 142.[22] In addition, the provision provides that the five-year spending period may be extended by the Secretary upon the qualified issuer's request.

Unlike qualified zone academy bonds, the provision requires issuers of CREBs to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds. Under the provision, there is a national limitation of $800 million of CREBs that the Secretary may allocate, in the aggregate, to qualified projects. However, the Secretary shall not allocate more than $500 million of CREBs to finance qualified projects for qualified borrowers that are governmental bodies. The authority to issue CREBs expires December 31, 2007.

### *Effective Date*

The provision is effective for bonds issued after December 31, 2005.

[22] Treas. Reg. sec. 1.142–2(e).

### 3. Treatment of certain income of electric cooperatives (sec. 1304 of the Act and sec. 501(c)(12) of the Code)

#### *Present Law*

***In general***

Under present law, an entity must be operated on a cooperative basis in order to be treated as a cooperative for Federal income tax purposes. Although not defined by statute or regulation, the two principal criteria for determining whether an entity is operating on a cooperative basis are: (1) ownership of the cooperative by persons who patronize the cooperative; and (2) return of earnings to patrons in proportion to their patronage. The Internal Revenue Service requires that cooperatives must operate under the following principles: (1) subordination of capital in control over the cooperative undertaking and in ownership of the financial benefits from ownership; (2) democratic control by the members of the cooperative; (3) vesting in and allocation among the members of all excess of operating revenues over the expenses incurred to generate revenues in proportion to their participation in the cooperative (patronage); and (4) operation at cost (not operating for profit or below cost).[23]

In general, cooperative members are those who participate in the management of the cooperative and who share in patronage capital. As described below, income from the sale of electric energy by an electric cooperative may be member or non-member income to the cooperative, depending on the membership status of the purchaser. A municipal corporation may be a member of a cooperative.

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception-the cooperative may exclude from its taxable income distributions of patronage dividends. In general, patronage dividends are the profits of the cooperative that are rebated to its patrons pursuant to a pre-existing obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative.

Except for tax-exempt farmers' cooperatives, cooperatives that are subject to the cooperative tax rules of subchapter T of the Code[24] are permitted a deduction for patronage dividends from their taxable income only to the extent of net income that is derived from transactions with patrons who are members of the cooperative.[25] The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative.

Cooperatives that qualify as tax-exempt farmers' cooperatives are permitted to exclude patronage dividends from their taxable income to the extent of all net income, including net income that is derived from transactions with patrons who are not members of the cooperative, provided the value of transactions with patrons who are not

[23] Announcement 96–24, "Proposed Examination Guidelines Regarding Rural Electric Cooperatives," 1996–16 I.R.B. 30.
[24] Sec. 1381, et seq.
[25] Sec. 1382.

members of the cooperative does not exceed the value of transactions with patrons who are members of the cooperative.[26]

### *Taxation of electric cooperatives exempt from subchapter T*

In general, the cooperative tax rules of subchapter T apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, other tax-exempt organizations, and certain utilities), including tax-exempt farmers' cooperatives (described in sec. 521(b)). However, subchapter T does not apply to an organization that is "engaged in furnishing electric energy, or providing telephone service, to persons in rural areas."[27] Instead, electric cooperatives are taxed under rules that were generally applicable to cooperatives prior to the enactment of subchapter T in 1962. Under these rules, an electric cooperative can exclude patronage dividends from taxable income to the extent of all net income of the cooperative, including net income derived from transactions with patrons who are not members of the cooperative.[28]

### *Tax exemption of rural electric cooperatives*

#### *In general*

Section 501(c)(12) provides an income tax exemption for rural electric cooperatives if at least 85 percent of the cooperative's income consists of amounts collected from members for the sole purpose of meeting losses and expenses of providing service to its members. The IRS takes the position that rural electric cooperatives also must comply with the fundamental cooperative principles described above in order to qualify for tax exemption under section 501(c)(12).[29] The 85-percent test is determined without taking into account any income from: (1) qualified pole rentals; (2) open access electric energy transmission services; (3) open access electric energy distribution services; (4) any nuclear decommissioning transaction; (5) any asset exchange or conversion transaction.[30]

#### *Income from open access transactions*

Income received or accrued by a rural electric cooperative (other than income received or accrued directly or indirectly from a member of the cooperative) from the provision or sale of electric energy transmission services or ancillary services on a nondiscriminatory open access basis under an open access transmission tariff approved or accepted by FERC or under an independent transmission provider agreement approved or accepted by FERC (including an agreement providing for the transfer of control-but not ownership-of transmission facilities) is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12).

In addition, income is excluded for purposes of the 85-percent test if it is received or accrued by a rural electric cooperative (other than income received or accrued directly or indirectly from a member of the cooperative) from the provision or sale of electric energy

[26] Sec. 521.
[27] Sec. 1381(a)(2)(C).
[28] See Rev. Rul. 83–135, 1983–2 C.B. 149.
[29] Rev. Rul. 72–36, 1972–1 C.B. 151.
[30] Sec. 501(c)(12)(C).

distribution services or ancillary services, provided such services are provided on a nondiscriminatory open access basis to distribute electric energy not owned by the cooperative: (1) to end-users who are served by distribution facilities not owned by the cooperative or any of its members; or (2) generated by a generation facility that is not owned or leased by the cooperative or any of its members and that is directly connected to distribution facilities owned by the cooperative or any of its members.

The exclusion for income from open access transactions does not apply to taxable years beginning after December 31, 2006.

*Income from nuclear decommissioning transactions*

Income received or accrued by a rural electric cooperative from any "nuclear decommissioning transaction" also is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). The term "nuclear decommissioning transaction" is defined as—

1. any transfer into a trust, fund, or instrument established to pay any nuclear decommissioning costs if the transfer is in connection with the transfer of the cooperative's interest in a nuclear powerplant or nuclear powerplant unit;

2. any distribution from a trust, fund, or instrument established to pay any nuclear decommissioning costs; or

3. any earnings from a trust, fund, or instrument established to pay any nuclear decommissioning costs.

The exclusion for income from nuclear decommissioning transactions does not apply to taxable years beginning after December 31, 2006.

*Income from asset exchange or conversion transactions*

Gain realized by a tax-exempt rural electric cooperative from a voluntary exchange or involuntary conversion of certain property is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). This provision only applies to the extent that: (1) the gain would qualify for deferred recognition under section 1031 (relating to exchanges of property held for productive use or investment) or section 1033 (relating to involuntary conversions); and (2) the replacement property that is acquired by the cooperative pursuant to section 1031 or section 1033 (as the case may be) constitutes property that is used, or to be used, for the purpose of generating, transmitting, distributing, or selling electricity or natural gas.

The exclusion for income from asset exchange or conversion transactions does not apply to taxable years beginning after December 31, 2006.

***Treatment of income from load loss transactions***

*Tax-exempt rural electric cooperatives*

Under present law, income received or accrued by a tax-exempt rural electric cooperative from a "load loss transaction" is treated under section 501(c)(12) as income collected from members for the sole purpose of meeting losses and expenses of providing service to

its members.[31] Therefore, income from load loss transactions is treated as member income in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under section 501(c)(12). In addition, income from load loss transactions does not cause a tax- exempt electric cooperative to fail to be treated for Federal income tax purposes as a mutual or cooperative company under the fundamental cooperative principles described above.

The term "load loss transaction" is generally defined as any wholesale or retail sale of electric energy (other than to a member of the cooperative) to the extent that the aggregate amount of such sales during a seven-year period beginning with the "start-up year" does not exceed the reduction in the amount of sales of electric energy during such period by the cooperative to members. The "start-up year" is defined as the first year that the cooperative offers non-discriminatory open access or, if later and at the election of the cooperative, 2004.

Present law also excludes income received or accrued by rural electric cooperatives from load loss transactions from the tax on unrelated trade or business income.

The special rule for income received or accrued by a tax-exempt rural electric cooperative from a load loss transaction does not apply to taxable years beginning after December 31, 2006.

*Taxable electric cooperatives*

The receipt or accrual of income from load loss transactions by taxable electric cooperatives is treated as income from patrons who are members of the cooperative.[32] Thus, income from a load loss transaction is excludible from the taxable income of a taxable electric cooperative if the cooperative distributes such income pursuant to a pre-existing contract to distribute the income to a patron who is not a member of the cooperative. In addition, income from load loss transactions does not cause a taxable electric cooperative to fail to be treated for Federal income tax purposes as a mutual or cooperative company under the fundamental cooperative principles described above.

The special rule for income received or accrued by a taxable electric cooperative from a load loss transaction does not apply to taxable years beginning after December 31, 2006.

### *Explanation of Provision*

The provision eliminates the sunset date for the rules excluding income received or accrued by tax-exempt rural electric cooperatives from open access electric energy transmission or distribution services, any nuclear decommissioning transaction, and any asset exchange or conversion transaction for purposes of the 85-percent test under section 501(c)(12). The provision also eliminates the sunset date for the rule that allows income from load loss transactions to be treated as member income in determining whether a rural electric cooperative satisfies the 85-percent test. In addition, the provision eliminates the sunset date for the rule that permits tax-

[31] Sec. 501(c)(12)(H).
[32] Sec. 501(c)(12)(H).

able electric cooperatives to treat the receipt or accrual of income from load loss transactions as income from patrons who are members of the cooperative.

### *Effective Date*

The provision is effective on the date of enactment (August 8, 2005).

## 4. Dispositions of transmission property to implement FERC restructuring policy (sec. 1305 of the Act and sec. 451 of the Code)

### *Present Law*

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

One such special tax provision permits taxpayers to elect to recognize gain from qualifying electric transmission transactions ratably over an eight-year period beginning in the year of sale if the amount realized from such sale is used to purchase exempt utility property within the applicable period[33] (the "reinvestment property"). If the amount realized exceeds the amount used to purchase reinvestment property, any realized gain is recognized to the extent of such excess in the year of the qualifying electric transmission transaction.

A qualifying electric transmission transaction is the sale or other disposition of property used by the taxpayer in the trade or business of providing electric transmission services, or an ownership interest in such an entity, to an independent transmission company prior to January 1, 2007. In general, an independent transmission company is defined as: (1) an independent transmission provider[34] approved by the FERC; (2) a person (i) who the FERC determines under section 203 of the Federal Power Act (or by declaratory order) is not a "market participant" and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider before the close of the period specified in such authorization, but not later than January 1, 2007; or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas State law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).

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

---

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

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

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

### *Explanation of Provision*

The Act extends the treatment under the present-law deferral provision to sales or dispositions to an independent transmission company prior to January 1, 2008. However, because the provision is an extension of a present law provision which expires on December 31, 2006, only transactions occurring after December 31, 2006, will be affected.

### *Effective Date*

The provision is effective for transactions occurring after the date of enactment (August 8, 2005).

## 5. Credit for production from advanced nuclear power facilities (sec. 1306 of the Act and new sec. 45J of the Code)

### *Present Law*

An income tax credit is allowed for production of electricity from qualified facilities sold by the taxpayer to an unrelated person (sec. 45). Qualified facilities comprise wind energy facilities, "closed-loop" biomass facilities, open-loop biomass (including agricultural livestock waste nutrients) facilities, geothermal energy facilities, solar energy facilities, small irrigation power facilities, landfill gas facilities, and trash combustion facilities. The base amount of the credit is 1.5 cents per kilowatt-hour (indexed for inflation) of electricity produced. The amount of the credit is 1.9 cents per kilowatt-hour for 2005. However, electricity produced at open-loop biomass, small irrigation power, and municipal solid waste facilities receives only 50 percent of the credit, or 0.9 cents per kilowatt-hour for 2005. Generally, wind and closed-loop biomass facilities may claim this credit for 10 years from the placed-in-service date of the facility. Other qualified facilities may claim the credit for only five years from the placed-in-service date.

Present law does not provide a credit for electricity produced at advanced nuclear power facilities.

### *Explanation of Provision*

The Act permits a taxpayer producing electricity at a qualifying advanced nuclear power facility to claim a credit equal to 1.8 cents per kilowatt-hour of electricity produced for the eight- year period starting when the facility is placed in service.[35] The aggregate amount of credit that a taxpayer may claim in any year during the

[35] The 1.8-cents credit amount is reduced, but not below zero, if the annual average contract price per kilowatt-hour of electricity generated from advanced nuclear power facilities in the preceding year exceeds eight cents per kilowatt-hour. The eight-cent price comparison level is indexed for inflation after 1992.

eight-year period is subject to limitation based on allocated capacity and an annual limitation as described below.

A qualifying advanced nuclear facility is an advanced nuclear facility for which the taxpayer has received an allocation of megawatt capacity from the Secretary and is placed in service before January 1, 2021. The taxpayer may only claim credit for production of electricity equal to the ratio of the allocated capacity that the taxpayer receives from the Secretary to the rated nameplate capacity of the taxpayer's facility. For example, if the taxpayer receives an allocation of 750 megawatts of capacity from the Secretary and the taxpayer's facility has a rated nameplate capacity of 1,000 megawatts, then the taxpayer may claim three-quarters of the otherwise allowable credit, or 1.35 cents per kilowatt-hour, for each kilowatt-hour of electricity produced at the facility (subject to the annual limitation described below). The Secretary may allocate up to 6,000 megawatts of capacity.

A taxpayer operating a qualified facility may claim no more than $125 million in tax credits per 1,000 megawatts of allocated capacity in any one year of the eight-year credit period. If the taxpayer operates a 1,350 megawatt rated nameplate capacity system and has received an allocation from the Secretary for 1,350 megawatts of capacity eligible for the credit, the taxpayer's annual limitation on credits that may be claimed is equal to 1.35 times $125 million, or $168.75 million. If the taxpayer operates a facility with a nameplate rated capacity of 1,350 megawatts, but has received an allocation from the Secretary for 750 megawatts of credit eligible capacity, then the two limitations apply such that the taxpayer may claim a credit equal to 1 cent per kilowatt-hour of electricity produced (as described above) subject to an annual credit limitation of $93.75 million in credits (three-quarters of $125 million).

An advanced nuclear facility is any nuclear facility for the production of electricity, the reactor design for which was approved after 1993 by the Nuclear Regulatory Commission. For this purpose, a qualifying advanced nuclear facility does not include any facility for which a substantially similar design for a facility of comparable capacity was approved before 1994.

In addition, the credit allowable to the taxpayer is reduced by reason of grants, tax-exempt bonds, subsidized energy financing, and other credits, but such reduction cannot exceed 50 percent of the otherwise allowable credit. The credit is treated as part of the general business credit.

### *Effective Date*

The provision applies to electricity produced in taxable years beginning after the date of enactment (August 8, 2005).

## 6. Credit for investment in clean coal facilities (sec. 1307 of the Act and new secs. 48A and 48B of the Code)

### *Present Law*

Present law does not provide an investment credit for electricity production facilities property that uses coal as a fuel or for the gasification of coal or other materials. However, a nonrefundable, 10-percent investment tax credit ("energy credit") is allowed for the

cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) that is used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage (sec. 48). The energy credit is a component of the general business credit (sec. 38(b)(1)).

### *Explanation of Provision*[36]

The provision creates two new 20-percent investment tax credits. Both credits are available only to projects certified by the Secretary of Treasury, in consultation with the Secretary of Energy. Certifications are issued using a competitive bidding process.

With respect to the first investment tax credit, the Secretary may allocate investment credits for projects using integrated gasification combined cycle ("IGCC") and other advanced coal-based electricity generation technologies based on the amount invested. Qualified projects must be economically feasible and use the appropriate clean coal technologies. The Secretary may allocate $800 million of credits to IGCC projects and $500 million of credits to projects using other advanced coal-based technologies.

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

Under the provision, the credit available to IGCC projects is 20 percent of qualified investments, and the credit for other advanced coal-based projects is 15 percent of qualified investments. With respect to IGCC projects, credit-eligible investments include only investments in property associated with the gasification of coal, including any coal handling and gas separation equipment. Thus, investments in equipment that could operate by drawing fuel directly from a natural gas pipeline do not qualify for the credit.

With respect to the second investment tax credit, the provision authorizes certification of certain gasification projects. Qualified gasification projects convert coal, petroleum residue, biomass, or other materials recovered for their energy or feedstock value into a synthesis gas composed primarily of carbon monoxide and hydrogen for direct use or subsequent chemical or physical conversion. Under the provision, certified gasification projects are eligible for the new 20 percent investment tax credit.

Under the provision, the total amount of gasification credits allocable by the Secretary is $350 million. In addition, a maximum of $650 million of credit-eligible investment may be allocated to any single gasification project. The provision specifies that only property which is part of a qualifying gasification project and necessary for the gasification technology of such project is eligible for the gasification credit.

---

[36] The provision was subsequently modified in Division A, section 201 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

### *Effective Date*

The credits apply to periods after the date of enactment (August 8, 2005), under rules similar to the rules of section 48(m) (as in effect before its repeal).

## 7. Transmission property treated as fifteen-year property (sec. 1308 of the Act and sec. 168 of the Code)

### *Present Law*

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87–56.[37] Assets used in the transmission and distribution of electricity for sale and related land improvements are assigned a 20–year recovery period and a class life of 30 years.

### *Explanation of Provision*

The provision establishes a statutory 15-year recovery period and a class life of 30 years for certain assets used in the transmission of electricity for sale and related land improvements. For purposes of the provision, section 1245 property used in the transmission at 69 or more kilovolts of electricity for sale, the original use of which commences with the taxpayer after April 11, 2005, will qualify for the new recovery period.

### *Effective Date*

The provision is generally effective for property placed in service after April 11, 2005. However, the provision does not apply to property which is the subject of a binding contract on or before April 11, 2005.[38]

## 8. Amortization of atmospheric pollution control facilities (sec. 1309 of the Act and sec. 169 of the Code)

### *Present Law*

In general, a taxpayer may elect to recover the cost of any certified pollution control facility over a period of 60 months.[39] A certified pollution control facility is defined as a new, identifiable treatment facility which (1) is used in connection with a plant in operation before January 1, 1976, to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes or heat; and (2) does not lead to a significant increase in output or capacity, a significant extension of useful life, a significant reduction in total operating costs for such plant or other property (or any unit thereof), or a significant alter-

[37] 1987–2 C.B. 674 (as clarified and modified by Rev. Proc. 88–22, 1988–1 C.B. 785).

[38] In the case of self-constructed property, the provision does not apply to property under construction on or before April 11, 2005.

[39] Sec. 169. For purposes of computing alternative minimum taxable income, the depreciation deduction is determined using the straight-line method over the applicable regular tax recovery period.

ation in the nature of a manufacturing production process or facility. Certification is required by appropriate State and Federal authorities that the facility complies with appropriate standards.

For a pollution control facility with a useful life greater than 15 years, only the portion of the basis attributable to the first 15 years is eligible to be amortized over a 60-month period.[40] In addition, a corporate taxpayer must reduce the amount of basis otherwise eligible for the 60-month recovery by 20 percent.[41] The amount of basis not eligible for 60-month amortization is depreciable under the regular tax rules for depreciation.

### *Explanation of Provision*

Under the provision, a certified air pollution control facility (but not a water pollution control facility) used in connection with an electric generation plant which is primarily coal fired will be eligible for 84-month amortization if the associated plant or other property was not in operation prior to January 1, 1976. The present-law 60-month amortization period remains in effect for any certified air pollution control facility used in connection with an electric generation plant which is primarily coal fired and which was in operation prior to January 1, 1976.

In the case of a facility used in connection with a plant or other property not in operation before January 1, 1976, the facility must be property that either (i) the construction, reconstruction, or erection of which is completed by the taxpayer after April 11, 2005 (to the extent of the portion of the basis properly attributable to the construction, reconstruction, or erection after that date), or (ii) is acquired after April 11, 2005, if the original use of the property commences with the taxpayer after that date. The provision does not change the present-law rules relating to corporate taxpayers or to pollution control facilities with a useful life greater than 15 years, and the provision does not modify in any way the treatment of water pollution control facilities.

### *Effective Date*

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

## 9. Modification to special rules for nuclear decommissioning costs (sec. 1310 of the Act and sec. 468A of the Code)

### *Present Law*

#### *Overview*

Special rules dealing with nuclear decommissioning reserve funds were enacted in the Deficit Reduction Act of 1984 ("1984 Act"), when tax issues regarding the time value of money were addressed generally. Under general tax accounting rules, a deduction for accrual basis taxpayers is deferred until there is economic per-

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

[41] Sec. 291(a)(5).

formance for the item for which the deduction is claimed. However, the 1984 Act contains an exception under which a taxpayer responsible for nuclear powerplant decommissioning may elect to deduct contributions made to a qualified nuclear decommissioning fund for future decommissioning costs. Taxpayers who do not elect this provision are subject to general tax accounting rules.

***Qualified nuclear decommissioning fund***

A qualified nuclear decommissioning fund (a "qualified fund") is a segregated fund established by a taxpayer that is used exclusively for the payment of decommissioning costs, taxes on fund income, management costs of the fund, and for making investments. The income of the fund is taxed at a reduced rate of 20 percent for taxable years beginning after December 31, 1995.[42]

Contributions to a qualified fund are deductible in the year made to the extent that these amounts were collected as part of the cost of service to ratepayers (the "cost of service requirement").[43] Funds withdrawn by the taxpayer to pay for decommissioning costs are included in the taxpayer's income, but the taxpayer also is entitled to a deduction for decommissioning costs as economic performance for such costs occurs.

Accumulations in a qualified fund are limited to the amount required to fund decommissioning costs of a nuclear powerplant for the period during which the qualified fund is in existence (generally post-1984 decommissioning costs of a nuclear powerplant). For this purpose, decommissioning costs are considered to accrue ratably over a nuclear powerplant's estimated useful life. In order to prevent accumulations of funds over the remaining life of a nuclear powerplant in excess of those required to pay future decommissioning costs of such nuclear powerplant and to ensure that contributions to a qualified fund are not deducted more rapidly than level funding (taking into account an appropriate discount rate), taxpayers must obtain a ruling from the IRS to establish the maximum annual contribution that may be made to a qualified fund (the "ruling amount"). In certain instances (e.g., change in estimates), a taxpayer is required to obtain a new ruling amount to reflect updated information.

A qualified fund may be transferred in connection with the sale, exchange or other transfer of the nuclear powerplant to which it relates. If the transferee is a regulated public utility and meets certain other requirements, the transfer will be treated as a nontaxable transaction. No gain or loss will be recognized on the transfer of the qualified fund and the transferee will take the transferor's basis in the fund.[44] The transferee is required to obtain a

---

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

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

[44] Treas. Reg. sec. 1.468A–6.

new ruling amount from the IRS or accept a discretionary determination by the IRS.[45]

### *Nonqualified nuclear decommissioning funds*

Federal and State regulators may require utilities to set aside funds for nuclear decommissioning costs in excess of the amount allowed as a deductible contribution to a qualified fund. In addition, taxpayers may have set aside funds prior to the effective date of the qualified fund rules.[46] The treatment of amounts set aside for decommissioning costs prior to 1984 varies. Some taxpayers may have received no tax benefit while others may have deducted such amounts or excluded such amounts from income. Since 1984, taxpayers have been required to include in gross income customer charges for decommissioning costs (sec. 88), and a deduction has not been allowed for amounts set aside to pay for decommissioning costs except through the use of a qualified fund. Income earned in a nonqualified fund is taxable to the fund's owner as it is earned.

## *Explanation of Provision*

### *Repeal of cost of service requirement*

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

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

The provision also repeals the limitation that a qualified fund only accumulate an amount sufficient to pay for a nuclear powerplant's decommissioning costs incurred during the period that the qualified fund is in existence (generally post-1984 decommissioning costs). Thus, any taxpayer is permitted to accumulate an amount sufficient to cover the present value of 100 percent of a nuclear powerplant's estimated decommissioning costs in a qualified fund. The provision does not change the requirement that contributions to a qualified fund not be deducted more rapidly than level funding.

### *Exception to ruling amount for certain decommissioning costs*

The provision permits a taxpayer to make contributions to a qualified fund in excess of the ruling amount in one circumstance. Specifically, a taxpayer is permitted to contribute up to the present value of total nuclear decommissioning costs with respect to a nuclear powerplant previously excluded under section 468A(d)(2)(A).[47] It is anticipated that an amount that is permitted to be contributed under this special rule shall be determined using the estimate of

[45] Treas. Reg. sec. 1.468A–6(f).

[46] These funds are generally referred to as "nonqualified funds."

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

total decommissioning costs used for purposes of determining the taxpayer's most recent ruling amount. Any amount transferred to the qualified fund under this special rule is allowed as a deduction over the remaining useful life of the nuclear powerplant.[48] If a qualified fund that has received amounts under this rule is transferred to another person, the transferor will be permitted a deduction for any remaining deductible amounts at the time of transfer.

The provision requires that a taxpayer apply for a new ruling amount with respect to a nuclear powerplant in any tax year in which the powerplant is granted a license renewal, extending its useful life.

### *Effective Date*

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

## 10. Five-year carryback of net operating losses for certain electric utility companies (sec. 1311 of the Act and sec. 172 of the Code)

### *Present Law*

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.[49] Under present-law ordering rules, NOLs generally are first applied to the earliest of the taxable years to which the loss may be carried.[50]

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).

Section 202 of the Job Creation and Worker Assistance Act of 2002[51] ("JCWAA") provided a temporary extension of the general NOL carryback period to five years (from two years) for NOLs arising in taxable years ending in 2001 and 2002. In addition, the five-year carryback period applies to NOLs from these years that qualify under present law for a three- year carryback period (i.e., NOLs

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

[49] Sec. 172.

[50] Sec. 172(b)(2).

[51] Pub. L. No. 107–147.

arising from casualty or theft losses of individuals or attributable to certain Presidentially declared disaster areas).

A taxpayer can elect to forgo the five-year carryback period. The election to forgo the five-year carryback period is made in the manner prescribed by the Secretary of the Treasury and must be made by the due date of the return (including extensions) for the year of the loss. The election is irrevocable. If a taxpayer elects to forgo the five-year carryback period, then the losses are subject to the rules that otherwise would apply under section 172 absent the provision.

### *Explanation of Provision*

The provision provides an election for certain electric utility companies to extend the carryback period to five years for a portion of NOLs arising in 2003, 2004, and 2005 ("loss years"). The election may be made during any taxable year ending after December 31, 2005, and before January 1, 2009 ("election years"). An electing taxpayer must specify to which loss year the election applies.

The portion of the loss year NOL to which the election may apply is limited to 20 percent of the amount of the taxpayer's qualifying investment in the taxable year prior to the year in which the election is made (the "qualifying investment limitation"). Rules similar to those applicable to specified liability losses apply, and any remaining portion of the loss year NOL remains subject to the present law NOL carryover rules. Only one election may be made in any election year, and elections may not be made for more than one election year beginning in the same calendar year. Thus, for example, a taxpayer with two short taxable years beginning in calendar year 2006 is eligible to make an election under this provision in only one of those two short taxable years. Once an election has been made with respect to a loss year, no subsequent election is available with respect to that loss year.

For purposes of calculating interest on overpayments, any overpayment resulting from a five-year NOL carryback elected under this provision is deemed not to have been made prior to the filing date for the taxable year in which the election is made. The statute of limitations for refund claims, and that for assessment of deficiencies, are also extended.

An election under this provision is made in such manner as the Secretary may prescribe. However, Congress expects that the filing of a refund claim will be considered sufficient for making the election, provided that the taxpayer attaches to the refund claim a statement specifying the election year, the loss year, and the amount of qualifying investment in electric transmission property and pollution control facilities in the preceding taxable year.

Under the provision, an investment in electric transmission property qualifies if it is a capital expenditure made by the taxpayer which is attributable to electric transmission property used by the taxpayer in the transmission at 69 or more kilovolts of electricity for sale. An investment in pollution control equipment qualifies if it is a capital expenditure, made by an electric utility company (as defined in the Public Utility Holding Company Act as in effect on the day before the date of enactment of the provision), which is attributable to a facility which will qualify as a certified pollution control facility, generally as defined under section 169(d)(1) but

without regard to the requirements therein that the facility be new or that it be used in connection with a plant or other property in operation before January 1, 1976.

The Congress recognizes that a significant amount of time may be required between the date of a capital expenditure for electric transmission property or pollution control equipment and the date the property is placed in service. Accordingly, there is no requirement that the transmission property or pollution control facilities be placed in service in the year in which the capital expenditures are incurred. However, it is intended that qualifying investment under the provision includes only capital expenditures to which the taxpayer is committed and with respect to property which the taxpayer intends to ultimately place in service in the taxpayer's trade or business. Under the provision, capital expenditures which, at the taxpayer's option, are refundable or subject to material modification in a manner which would not meet the requirements of the provision, may not be taken into account. For example, if a taxpayer makes a cash deposit with respect to a contract for the purchase of electric transmission property, and the contract contains an option (or there is otherwise an understanding) under which the taxpayer may subsequently apply the deposit to the purchase of equipment other than electric transmission property, the deposit is not included in the taxpayer's qualifying investment. This rule is intended as an anti-abuse rule and should be interpreted to prevent a taxpayer from taking into account capital expenditures to which the taxpayer is not permanently committed.

### *Effective Date*

The provision is effective for elections made in taxable years ending after December 31, 2005.

## 11. Modification of credit for producing fuel from a non-conventional source (secs. 1321 and 1322 of the Act and sec. 29 and new sec. 45K of the Code)

### *Present Law*

Certain fuels produced from "non-conventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation)[52] per barrel or Btu oil barrel equivalent ("section 29 credit"). Qualified fuels must be produced within the United States.

Qualified fuels include:

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

Generally, the section 29 credit has expired, except for certain biomass gas and synthetic fuels sold before January 1, 2008, and produced at facilities placed in service after December 31, 1992, and before July 1, 1998.

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

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

Other business credits are included in the general business credit (sec. 38). Generally, the general business credit may not exceed the excess of the taxpayer's net income tax over the greater of the taxpayer's tentative minimum tax or 25 percent of so much of the taxpayer's net regular tax liability as exceeds $25,000. General business credits in excess of this limitation may be carried back one year and forward up to 20 years. The section 29 credit is not part of the general business credit.

The section 29 credit includes definitional cross-references and a credit limitation relating to the Natural Gas Policy Act of 1978. The Natural Gas Policy Act of 1978 has been repealed.

### *Reasons for Change*

The Congress recognizes that the section 29 credit is not part of the general business credits and therefore no carryback or carryforward is available for the credit. The Congress believes that the carryback and carryforward rules should apply to the credit, and therefore believes it is appropriate to treat the credit as part of the general business credits.

### *Explanation of Provision* [53]

The provision makes the credit for producing fuel from a non-conventional source part of the general business credit. Thus, the credit for producing fuel from a non-conventional source will be subject to the limitations applicable to the general business credit. Any unused credits may be carried back one year and forward 20 years.

In addition to making the section 29 credit part of the general business credit, the provision adds a production credit for qualified facilities that produce coke or coke gas. Qualified facilities must have been placed in service before January 1, 1993, or after June 30, 1998, and before January 1, 2010. A single facility for the production of coke or coke gas is generally composed of multiple coke ovens or similar structures.

The production credit may be claimed with respect to coke and coke gas produced and sold during the period beginning on the later of January 1, 2006, or the date such facility is placed in service and ending on the date which is four years after such period began. The amount of credit-eligible coke produced may not exceed an average barrel-of-oil equivalent of 4,000 barrels per day. The $3.00 credit for coke or coke gas is indexed for inflation using 2004 as the base year instead of 1979. A facility that has claimed a credit under Code section 29(g) is not eligible to claim the new credit for producing coke or coke gas.

[53] The provision was subsequently modified in Division A, section 211 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

The Congress understands that the Internal Revenue Service has stopped issuing private letter rulings and other taxpayer-specific guidance regarding the section 29 credit. The Congress believes that the Internal Revenue Service should consider issuing such rulings and guidance on an expedited basis to those taxpayers who had pending ruling requests at the time the moratorium was implemented.

The provision also makes certain clerical changes in cross-references to the Natural Gas Policy Act of 1978, which has been repealed.

### *Effective Date*

The provision applies to credits determined for taxable years ending after December 31, 2005.[54] The clerical changes are effective on the date of enactment.

## 12. Temporary expensing for equipment used in the refining of liquid fuels (sec. 1323 of the Act and new sec. 179C of the Code)

### *Present Law*

#### *Depreciation of refinery assets*

Under present law, depreciation allowances for property used in a trade or business generally are determined under the Modified Accelerated Cost Recovery System ("MACRS") of section 168 of the Internal Revenue Code. Under MACRS, petroleum refining assets are depreciated for regular tax purposes over a 10-year recovery period using the double declining balance method. Petroleum refining assets are assets used for distillation, fractionation, and catalytic cracking of crude petroleum into gasoline and its other components. Present law also provides a special expensing rule for small refiners for capital costs incurred in complying with Environmental Protection Agency sulfur regulations.

#### *Taxation of cooperatives and their patrons*

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception—the cooperative may exclude from its taxable income distributions of patronage dividends. Generally, cooperatives that are subject to the cooperative tax rules of subchapter T of the Code[55] are permitted a deduction for patronage dividends from their taxable income only to the extent of net income that is derived from transactions with patrons who are members of the cooperative.[56] The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative.

---

[54] The credit may not be carried back to a taxable year ending before January 1, 2006 (sec. 39(d)).

[55] Sec. 1381, et seq.

[56] Sec. 1382.

### *Explanation of Provision*

The provision provides a temporary election to expense 50 percent of qualified refinery property.[57] The remaining 50 percent is recovered as under present law. Qualified refinery property includes assets, located in the United States, used in the refining of liquid fuels: (1) with respect to the construction of which there is a binding construction contract before January 1, 2008;[58] (2) which are placed in service before January 1, 2012; (3) which increase the capacity of an existing refinery by at least five percent[59] or increase the percentage of total throughput[60] attributable to qualified fuels (as defined in present law section 29(c), which is redesignated as section 45K(c) by section 1322(a)(1) of the Act)[61] such that it equals or exceeds 25 percent; and (4) which meet all applicable environmental laws in effect when the property is placed in service.[62]

The expensing election is not available with respect to identifiable refinery property built solely to comply with consent decrees or projects mandated by Federal, State, or local governments. For example, a taxpayer may not elect to expense the cost of a scrubber, even if the scrubber is installed as part of a larger project, if the scrubber does not increase throughput or increased capacity to accommodate qualified fuels and is necessary for the refinery to comply with the Clean Air Act. This exclusion applies regardless of whether the mandate or consent decree addresses environmental concerns with respect to the refinery itself or the refined fuels.

The provision allows cooperative organizations to pass through to the owners of such organizations the expensing deduction for qualified refinery property. To the extent the deduction is passed through to owners, the cooperative is denied deductions it would otherwise be entitled with respect to qualified refinery property. Under the provision, a cooperative organization electing to pass the expensing deduction through to its owners must make such an election on the tax return for the taxable year to which the deduction

---

[57] For purposes of the provision, the term "refinery" refers to facilities the primary purpose of which is the processing of crude oil (whether or not previously refined) or qualified fuels (as defined in present law section 29(c), which is redesignated as section 45K(c) under section 1322(a)(1) of the Act). The limitation of present law section 29(d) (redesignated as section 45K(d) under the Act) requiring domestic production of qualified fuels is not applicable with respect to the definition of refinery under this provision; thus, otherwise qualifying refinery property will be eligible for the provision even if the primary purpose of the refinery is the processing of oil produced from shale and tar sands outside the United States. The term refinery would include a facility which processes coal via gas into liquid fuel.

[58] This requirement also may be met by placing the property in service before January 1, 2008 or, in the case of self-constructed property, by beginning construction after June 14, 2005 and before January 1, 2008.

[59] The five percent capacity requirement refers to the output capacity of the refinery, as measured by the volume of finished products other than asphalt and lube oil, rather than input capacity, as measured by rated capacity.

[60] For purposes of the provision, the throughput of a refinery is measured on the basis of barrels per calendar day. Barrels per calendar day is the amount of fuels that a facility can process under usual operating conditions, expressed in terms of capacity during a 24-hour period and reduced to account for down time and other limitations.

[61] The limitation of present law section 29(d) (redesignated as section 45K(d) under section 1322(a)(1) of the Act) regarding domestic production is not applicable with respect to the definition of qualified fuels under this provision.

[62] The requirement to meet all applicable environmental laws applies specifically to the refinery or portion of a refinery placed in service after the date of enactment. A refinery's failure to meet applicable environmental laws with respect to a portion of the refinery which was in service prior to the effective date will not disqualify the taxpayer from making the election under the provision with respect to otherwise qualifying refinery property.

relates. Once made, the election is irrevocable. Moreover, the organization making the election must provide cooperative owners receiving an allocation of the deduction written notice of the amount of such allocation.

As a condition of eligibility for the expensing of equipment used in the refining of liquid fuels, the provision provides that a refinery must report to the IRS concerning its refinery operations (e.g. production and output).

### *Effective Date*

The provision is effective for property placed in service after the date of enactment (August 8, 2005), the original use of which begins with the taxpayer, provided the property was not subject to a binding contract for construction on or before June 14, 2005. An exception to the original use requirement is provided for property which would meet the requirement but for a sale-leaseback transaction within the first three months after the property is originally placed in service.

## 13. Allow pass through to owners of deduction for capital costs incurred by small refiner cooperative in complying with environmental protection agency sulfur regulations (sec. 1324 of the Act and sec. 179B of the Code)

### *Present Law*

#### *Expensing and credit for small refiners*

Taxpayers generally may recover the costs of investments in refinery property through annual depreciation deductions. In addition, the Code permits small business refiners to immediately deduct as an expense up to 75 percent of the costs paid or incurred for the purpose of complying with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency ("EPA"). Costs qualifying for the deduction are those costs paid or incurred with respect to any facility of a small business refiner during the period beginning on January 1, 2003 and ending on the earlier of the date that is one year after the date on which the taxpayer must comply with the applicable EPA regulations or December 31, 2009.

The Code also provides that a small business refiner may claim a credit equal to five cents per gallon for each gallon of low sulfur diesel fuel produced during the taxable year that is in compliance with the Highway Diesel Fuel Sulfur Control Requirements. The total production credit claimed by the taxpayer is limited to 25 percent of the capital costs incurred to come into compliance with the EPA diesel fuel requirements. As with the deduction permitted under present law, costs qualifying for the credit are those costs paid or incurred with respect to any facility of a small business refiner during the period beginning on January 1, 2003 and ending on the earlier of the date that is one year after the date on which the taxpayer must comply with the applicable EPA regulations or December 31, 2009. The taxpayer's basis in property with respect to which the credit applies is reduced by the amount of production credit claimed.

For these purposes, a small business refiner is a taxpayer who is within the business of refining petroleum products, employs not more than 1,500 employees directly in refining, and has less than 205,000 barrels per day (average) of total refinery capacity. The deduction is reduced, pro rata, for taxpayers with capacity in excess of 155,000 barrels per day.

In the case of a qualifying small business refiner that is owned by a cooperative, the cooperative is allowed to elect to pass any production credits to patrons of the organization. Present law does not permit cooperatives to pass through to members the deduction permitted for the costs paid or incurred for the purpose of complying with the Highway Diesel Fuel Sulfur Control Requirements.

***Taxation of cooperatives and their patrons***

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception—the cooperative may exclude from its taxable income distributions of patronage dividends. In general, patronage dividends are the profits of the cooperative that are rebated to its patrons pursuant to a pre-existing obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative.

Except for tax-exempt farmers' cooperatives, cooperatives that are subject to the cooperative tax rules of subchapter T of the Code[63] are permitted a deduction for patronage dividends from their taxable income only to the extent of net income that is derived from transactions with patrons who are members of the cooperative.[64] The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative.

Cooperatives that qualify as tax-exempt farmers' cooperatives are permitted to exclude patronage dividends from their taxable income to the extent of all net income, including net income that is derived from transactions with patrons who are not members of the cooperative, provided the value of transactions with patrons who are not members of the cooperative does not exceed the value of transactions with patrons who are members of the cooperative.[65]

## *Explanation of Provision*

The provision allows cooperatives to elect to pass through to their owners the deduction permitted for costs paid or incurred for the purpose of complying with the Highway Diesel Fuel Sulfur Control Requirements. The election must be made on the tax return of the organization for the taxable year to which the deduction relates. Once made, the election is irrevocable. In addition, the organization making such an election must provide cooperative owners receiving an allocation of the deduction written notice of the amount of such allocation. The written notice must be provided by the due date for the tax return on which the election is made. Fi-

[63] Sec. 1381, et seq.
[64] Sec. 1382.
[65] Sec. 521.

nally, to the extent the deduction is passed through to owners, the cooperative is denied deductions it would otherwise be entitled with respect to costs attributable to complying with the Highway Diesel Fuel Sulfur Control Requirements.

### *Effective Date*

The provision is effective as if included in the amendments made by section 338(a) of the American Jobs Creation Act of 2004 (effective for expenses paid or incurred after December 31, 2002, in taxable years ending after such date).[66]

## 14. Natural gas distribution lines treated as fifteen-year property (sec. 1325 of the Act and sec. 168 of the Code)

### *Present Law*

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87-56.[67] Natural gas distribution pipelines are assigned a 20-year recovery period and a class life of 35 years.

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective for property, the original use of which begins with the taxpayer after April 11, 2005, which is placed in service after April 11, 2005 and before January 1, 2011. The provision does not apply to property subject to a binding contract on or before April 11, 2005.[68]

## 15. Natural gas gathering lines treated as seven-year property (sec. 1326 of the Act and sec. 168 of the Code)

### *Present Law*

The applicable recovery period for assets placed in service under the Modified Accelerated Cost Recovery System is based on the "class life of the property." The class lives of assets placed in service after 1986 are generally set forth in Revenue Procedure 87–56.[69] Revenue Procedure 87–56 includes two asset classes either of which could describe natural gas gathering lines owned by nonproducers of natural gas. Asset class 46.0, describing pipeline transportation, provides a class life of 22 years and a recovery period of 15 years. Asset class 13.2, describing assets used in the exploration for and production of petroleum and natural gas deposits, provides a class life of 14 years and a depreciation recovery period of seven

[66] Pub. L. No. 108–357.
[67] 1987–2 C.B. 674 (as clarified and modified by Rev. Proc. 88–22, 1988–1 C.B. 785).
[68] In the case of self-constructed property, the provision does not apply to property under construction on or before April 11, 2005.
[69] 1987–2 C.B. 674 (as clarified and modified by Rev. Proc. 88–22, 1988–1 C.B. 785).

years. The uncertainty regarding the appropriate recovery period of natural gas gathering lines has resulted in litigation between taxpayers and the IRS. In each of three recent cases, appellate courts have held that natural gas gathering lines owned by nonproducers fall within the scope of Asset class 13.2 (i.e., seven-year recovery period).[70] The appellate court in each case reversed a lower court holding that natural gas gathering lines owned by nonproducers fall within the scope of Asset class 46.0 (i.e., 15-year recovery period). The IRS issued a non-acquiesence in *Duke Energy*, in IRS Action on Decision 1999–17 (November 22, 1999). The IRS has not yet indicated whether it acquiesces in the result in the two other appellate decisions.

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective for property, the original use of which begins with the taxpayer, which was placed in service after April 11, 2005. The provision does not apply to property with respect to which the taxpayer (or a related party) had a binding acquisition contract on or before April 11, 2005. No inference is intended as to the proper treatment of natural gas gathering lines placed in service on or before April 11, 2005.

## 16. Arbitrage rules not to apply to prepayments for natural gas (sec. 1327 of the Act and sec. 148 of the Code)

### *Present Law*

#### *Arbitrage restrictions*

Interest on bonds issued by States or local governments to finance activities carried out or paid for by those entities generally is exempt from income tax. Restrictions are imposed on the ability of States or local governments to invest the proceeds of these bonds for profit (the "arbitrage restrictions").[71] One such restriction lim-

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

[71] Sec. 148.

its the use of bond proceeds to acquire "investment-type property." The term investment-type property includes the acquisition of property in a transaction involving a prepayment if a principal purpose of the prepayment is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. A prepayment can produce prohibited arbitrage profits when the discount received for prepaying the costs exceeds the yield on the tax-exempt bonds. In general, prohibited prepayments include all prepayments that are not customary in an industry by both beneficiaries of tax-exempt bonds and other persons using taxable financing for the same transaction.

On August 4, 2003, the Treasury Department issued final regulations deeming to be customary, and not in violation of the arbitrage rules, certain prepayments for natural gas and electricity.[72] Generally, a qualified prepayment under the regulations requires that 90 percent of the natural gas or electricity purchased with the prepayment be used for a qualifying use. Generally, natural gas is used for a qualifying use if it is to be (1) furnished to retail gas customers of the issuing municipal utility who are located in the natural gas service area of the issuing municipal utility, however, gas used to produce electricity for sale is not included under this provision (2) used by the issuing municipal utility to produce electricity that will be furnished to retail electric service area customers of the issuing utility, (3) used by the issuing municipal utility to produce electricity that will be sold to a utility owned by a governmental person and furnished to the service area retail electric customers of the purchaser, (4) sold to a utility that is owned by a governmental person if the requirements of (1), (2) or (3) are satisfied by the purchasing utility (treating the purchaser as the issuing utility) or (5) used to fuel the pipeline transportation of the prepaid gas supply. Electricity is used for a qualifying use if it is to be (1) furnished to retail service area electric customers of the issuing municipal utility or (2) sold to a municipal utility and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser.

### *Private activity bond tests*

State and local bonds may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are primarily repaid with governmental funds. Private activity bonds are bonds where the State or local government serves as a conduit providing financing to private businesses or individuals. A bond will be treated as a private activity bond if more than five percent of the proceeds of the bond issue, or, if less, more than $5,000,000 is used (directly or indirectly) to make or finance loans to persons other than governmental units (the "private loan financing test") or if it meets the requirements of a two-part private business test.[73]

---

[72] Treas. Reg. sec. 1.148–1(e)(2)(iii).

[73] Sec. 141(b) and (c). Under the private business test, a bond is a private activity bond if it is part of an issue in which: (1) more than 10 percent of the proceeds of the issue (including use of the bond-financed property) are to be used in the trade or business of any person other

Continued

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

### *Reasons for Change*

The Congress determined that it was appropriate to complement the Treasury regulations with a safe harbor that provides certainty on the date of issuance that prepayments for natural gas within the safe harbor will not violate the arbitrage rules. This provision will ensure adequate supplies of natural gas at predictable prices for natural gas utility customers without sacrificing to a great degree the appropriate present-law limitations regarding tax-exempt bond issuance for the purchase of investment property. The Congress believes that this proposal strikes an appropriate balance between these two competing policies. The creation of this safe harbor is not intended to limit the Secretary's regulatory authority to identify other situations in which prepayments do not give rise to investment type property.

### *Explanation of Provision*

#### *In general*

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

Under the provision, a prepayment financed with tax-exempt bond proceeds for the purpose of obtaining a supply of natural gas for service area customers of a governmental utility is not treated as the acquisition of investment-type property. A contract is a qualified natural gas contract if the volume of natural gas secured for any year covered by the prepayment does not exceed the sum of (1) the average annual natural gas purchased (other than for resale) by customers of the utility within the service area of the util-

---

than a governmental unit ("private business use"); and (2) more than 10 percent of the payment of principal or interest on the issue is, directly or indirectly, secured by (a) property used or to be used for a private business use or (b) to be derived from payments in respect of property, or borrowed money, used or to be used for a private business use ("private payment test").

ity ("retail natural gas consumption") during the testing period, and (2) the amount of natural gas that is needed to fuel transportation of the natural gas to the governmental utility. The testing period is the 5-calendar-year period immediately preceding the calendar year in which the bonds are issued. A retail customer is one who does not purchase natural gas for resale. Natural gas used to generate electricity by a utility owned by a governmental unit is counted as retail natural gas consumption if the electricity was sold to retail customers within the service area of the governmental electric utility.

***Adjustments***

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

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

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

***Intentional acts***

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

***Definition of service area***

Service area is defined as (1) any area throughout which the governmental utility provided (at all times during the testing period) in the case of a natural gas utility, natural gas transmission or distribution services, or in the case of an electric utility, electricity distribution services; (2) limited areas contiguous to such areas,

and (3) any area recognized as the service area of the governmental utility under State or Federal law. Contiguous areas are limited to any area within a county contiguous to the area described in (1) in which retail customers of the utility are located if such area is not also served by another utility providing the same service.

***Ruling request for higher prepayment amounts***

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

***Nongovernmental output property restrictions***

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

***Application to joint action agencies***

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

### *Effective Date*

The provision is effective for bonds issued after the date of enactment (August 8, 2005).

## 17. Determination of small refiner exception to oil depletion deduction (sec. 1328 of the Act and sec. 613A of the Code)

### *Present Law*

Present law classifies oil and gas producers as independent producers or integrated companies. The Code provides special tax rules for operations by independent producers. One such rule allows independent producers to claim percentage depletion deduc-

tions rather than deducting the costs of their asset, a producing well, based on actual production from the well (i.e., cost depletion).

A producer is an independent producer only if its refining and retail operations are relatively small. For example, an independent producer may not have refining operations the runs from which exceed 50,000 barrels on any day in the taxable year during which independent producer status is claimed.[74] A refinery run is the volume of inputs of crude oil (excluding any product derived from oil) into the refining stream.[75]

### *Reasons for Change*

The Congress notes that technological advances have permitted a number of small refineries to refine more petroleum without expanding their facilities. The Congress believes that the goal of present law, to identify producers without significant refining capacity, can be achieved while permitting more flexibility to refinery operations.

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective for taxable years ending after date of enactment (August 8, 2005).

## 18. Amortization of geological and geophysical expenditures (sec. 1329 of the Act and sec. 167 of the Code)

### *Present Law*

#### *In general*

Geological and geophysical expenditures ("G&G costs") are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals. A key issue with respect to the tax treatment of such expenditures is whether or not they are capital in nature. Capital expenditures are not currently deductible as ordinary and necessary business expenses, but are allocated to the cost of the property.[76]

---

[74] Sec. 613A(d)(4).

[75] Treas. Reg. sec. 1.613A–7(s).

[76] Under section 263, capital expenditures are defined generally as any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Treasury regulations define capital expenditures to include amounts paid or

Continued

Courts have held that G&G costs are capital, and therefore are allocable to the cost of the property[77] acquired or retained. The costs attributable to such exploration are allocable to the cost of the property acquired or retained.[78] As described further below, IRS administrative rulings have provided further guidance regarding the definition and proper tax treatment of G&G costs.

### *Revenue Ruling 77–188*

In Revenue Ruling 77–188[79] (hereinafter referred to as the "1977 ruling"), the IRS provided guidance regarding the proper tax treatment of G&G costs. The ruling describes a typical geological and geophysical exploration program as containing the following elements:

- It is customary in the search for mineral producing properties for a taxpayer to conduct an exploration program in one or more identifiable project areas. Each project area encompasses a territory that the taxpayer determines can be explored advantageously in a single integrated operation. This determination is made after analyzing certain variables such as (1) the size and topography of the project area to be explored, (2) the existing information available with respect to the project area and nearby areas, and (3) the quantity of equipment, the number of personnel, and the amount of money available to conduct a reasonable exploration program over the project area.
- The taxpayer selects a specific project area from which geological and geophysical data are desired and conducts a reconnaissance-type survey utilizing various geological and geophysical exploration techniques. These techniques are designed to yield data that will afford a basis for identifying specific geological features with sufficient mineral potential to merit further exploration.
- Each separable, noncontiguous portion of the original project area in which such a specific geological feature is identified is a separate "area of interest." The original project area is subdivided into as many small projects as there are areas of interest located and identified within the original project area. If the circumstances permit a detailed exploratory survey to be conducted without an initial reconnaissance-type survey, the project area and the area of interest will be coextensive.
- The taxpayer seeks to further define the geological features identified by the prior reconnaissance-type surveys by additional, more detailed, exploratory surveys conducted with respect to each area of interest. For this purpose, the taxpayer engages in more intensive geological and geophysical explo-

---

incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer or (2) to adapt property to a new or different use. Treas. Reg. sec. 1.263(a)–1(b).

[77] "Property" means an interest in a property as defined in section 614 of the Code, and includes an economic interest in a tract or parcel of land notwithstanding that a mineral deposit has not been established or proved at the time the costs are incurred.

[78] See, *e.g., Schermerhorn Oil Corporation* v. *Commissioner,* 46 B.T.A. 151 (1942). By contrast, section 617 of the Code permits a taxpayer to elect to deduct certain expenditures incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (but not oil and gas). These deductions are subject to recapture if the mine with respect to which the expenditures were incurred reaches the producing stage.

[79] 1977–1 C.B. 76.

ration employing methods that are designed to yield sufficiently accurate sub-surface data to afford a basis for a decision to acquire or retain properties within or adjacent to a particular area of interest or to abandon the entire area of interest as unworthy of development by mine or well.

The 1977 ruling provides that if, on the basis of data obtained from the preliminary geological and geophysical exploration operations, only one area of interest is located and identified within the original project area, then the entire expenditure for those exploratory operations is to be allocated to that one area of interest and thus capitalized into the depletable basis of that area of interest. On the other hand, if two or more areas of interest are located and identified within the original project area, the entire expenditure for the exploratory operations is to be allocated equally among the various areas of interest.

If no areas of interest are located and identified by the taxpayer within the original project area, then the 1977 ruling states that the entire amount of the G&G costs related to the exploration is deductible as a loss under section 165. The loss is claimed in the taxable year in which that particular project area is abandoned as a potential source of mineral production.

A taxpayer may acquire or retain a property within or adjacent to an area of interest, based on data obtained from a detailed survey that does not relate exclusively to any discrete property within a particular area of interest. Generally, under the 1977 ruling, the taxpayer allocates the entire amount of G&G costs to the acquired or retained property as a capital cost under section 263(a). If more than one property is acquired, it is proper to determine the amount of the G&G costs allocable to each such property by allocating the entire amount of the costs among the properties on the basis of comparative acreage.

If, however, no property is acquired or retained within or adjacent to that area of interest, the entire amount of the G&G costs allocable to the area of interest is deductible as a loss under section 165 for the taxable year in which such area of interest is abandoned as a potential source of mineral production.

In 1983, the IRS issued Revenue Ruling 83–105,[80] which elaborates on the positions set forth in the 1977 ruling by setting forth seven factual situations and applying the principles of the 1977 ruling to those situations. In addition, Revenue Ruling 83–105 explains what constitutes "abandonment as a potential source of mineral production."

### *Reasons for Change*

The Congress believes that substantial simplification for taxpayers, significant gains in taxpayer compliance, and reductions in administrative cost can be obtained by establishing a clear rule that all geological and geophysical costs may be amortized over two years, including the basis of abandoned property.

The Congress recognizes that, on average, a two-year amortization period accelerates recovery of geological and geophysical ex-

[80] 1983–2 C.B. 51.

penses. The Congress believes that more rapid recovery of such expenses will foster increased exploration for new sources of supply.

### *Explanation of Provision* [81]

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

### *Effective Date*

The provision is effective for geological and geophysical costs paid or incurred in taxable years beginning after the date of enactment (August 8, 2005). No inference is intended from the prospective effective date of this provision as to the proper treatment of pre-effective date geological and geophysical costs.

## 19. Credit for energy efficient commercial buildings deduction (sec. 1331 of the Act and new sec. 179D of the Code)

### *Present Law*

No special deduction is provided for expenses incurred for energy-efficient commercial building property.

### *Explanation of Provision* [82]

#### *In general*

The provision provides a deduction for 2006 and 2007 equal to energy-efficient commercial building property expenditures made by the taxpayer. Energy-efficient commercial building property expenditures is defined as property (1) which is installed on or in any building located in the United States that is within the scope of Standard 90.1–2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America ("ASHRAE/IESNA"), (2) which is installed as part of (i) the interior lighting systems, (ii) the heating, cooling, ventilation, and hot water systems, or (iii) the building envelope, and (3) which is certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building which meets the minimum requirements of Standard 90.1–2001 (as in effect on April 2, 2003). The deduction is limited to an amount equal to $1.80 per square foot of the property for which such expenditures are made. The deduction is allowed in the year in which the property is placed in service and is available only for property placed in service after December 31, 2005 and prior to January 1, 2008.

---

[81] The provision was subsequently modified in section 503 of the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109–222, described in Part Eleven.

[82] The provision was subsequently extended in Division A, section 204 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

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

The Congress intends that the methods for calculation be fuel neutral, such that the same energy efficiency features qualify a building for the deduction under this provision regardless of whether the heating source is a gas or oil furnace or boiler or an electric heat pump. The Congress also intends that the calculation methods provide appropriate calculated energy savings for design methods and technologies not otherwise credited in either Standard 90.1–2001 or in the 2005 California Nonresidential Alternative Calculation Method Approval Manual, including the following: (i) Natural ventilation (ii) Evaporative cooling (iii) Automatic lighting controls such as occupancy sensors, photocells, and timeclocks( iv) Daylighting (v) Designs utilizing semi-conditioned spaces which maintain adequate comfort conditions without air conditioning or without heating (vi) Improved fan system efficiency, including reductions in static pressure (vii) Advanced unloading mechanisms for mechanical cooling, such as multiple or variable speed compressors (viii) On-site generation of electricity, including combined heat and power systems, fuel cells, and renewable energy generation such as solar energy (ix) Wiring with lower energy losses than wiring satisfying Standard 90.1–2001 requirements for building power distribution systems. The calculation methods may take into account the extent of commissioning in the building, and allow the taxpayer to take into account measured performance which exceeds typical performance.

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

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

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

***Partial allowance of deduction***

In the case of a building that does not meet the overall building requirement of a 50-percent energy savings, a partial deduction is allowed with respect to each separate building system that comprises energy efficient property and which is certified by a qualified professional as meeting or exceeding the applicable system-specific savings targets established by the Secretary of the Treasury. The

applicable system-specific savings targets to be established by the Secretary are those that would result in a total annual energy savings with respect to the whole building of 50 percent, if each of the separate systems met the system specific target. The separate building systems are (1) the interior lighting system, (2) the heating, cooling, ventilation and hot water systems, and (3) the building envelope. The maximum allowable deduction is $0.60 per square foot for each separate system.

In the case of system-specific partial deductions, in general no deduction is allowed until the Secretary establishes system-specific targets. However, in the case of lighting system retrofits, until such time as the Secretary issues final regulations, the system-specific energy savings target for the lighting system is deemed to be met by a reduction in Lighting Power Density of 40 percent (50 percent in the case of a warehouse) of the minimum requirements in Table 9.3.1.1 or Table 9.3.1.2 of ASHRAE/IESNA Standard 90.1–2001. Also, in the case of a lighting system that reduces lighting power density by 25 percent, a partial deduction of 37.5 cents per square foot is allowed. A pro-rated partial deduction is allowed in the case of a lighting system that reduces lighting power density between 25 percent and 40 percent. Certain lighting level and lighting control requirements must also be met in order to qualify for the partial lighting deductions.

### *Effective Date*

The provision is effective for property placed in service after December 31, 2005.

## 20. Credit for energy efficient new homes (sec. 1332 of the Act and new sec. 45L of the Code)

### *Present Law*

There is no present-law credit for the construction of new energy-efficient homes.

### *Explanation of Provision* [83]

The provision provides a credit for 2006 and 2007 to an eligible contractor for the construction of a qualified new energy-efficient home whose construction is substantially completed after December 31, 2005, and which is purchased after December 31, 2005 and prior to January 1, 2008. To qualify as an energy-efficient new home, the home must be: (1) a dwelling located in the United States, (2) substantially completed after the date of enactment, and (3) certified in accordance with guidance prescribed by the Secretary to have a projected level of annual heating and cooling energy consumption that meets the standards for either a 30-percent or 50-percent reduction in energy usage, compared to a comparable dwelling constructed in accordance with the standards of chapter 4 of the 2003 International Energy Conservation Code as in effect (including supplements) on the date of enactment (August 8, 2005), and any applicable Federal minimum efficiency standards for

[83] The provision was subsequently extended in Division A, section 205 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

equipment. With respect to homes that meet the 30-percent standard, one-third of such 30 percent savings must come from the building envelope, and with respect to homes that meet the 50-percent standard, one-fifth of such 50 percent savings must come from the building envelope.

The credit equals $1,000 in the case of a new home that meets the 30 percent standard and $2,000 in the case of a new home that meets the 50 percent standard. Only manufactured homes are eligible for the $1,000 credit.

The eligible contractor is the person who constructed the home, or in the case of a manufactured home, the producer of such home. The Congress intends that the building envelope component means insulation materials or system specifically and primarily designed to reduce heat loss or gain, exterior windows (including skylights), doors, and any duct sealing and infiltration reduction measures.

Manufactured homes that conform to federal manufactured home construction and safety standards are eligible for the credit provided all the criteria for the credit are met. Manufactured homes certified by a method prescribed by the Administrator of the Environmental Protection Agency under the Energy Star Labeled Homes program are eligible for the $1,000 credit provided criteria (1) and (2), above, are met.

The credit is part of the general business credit. No credits attributable to energy efficient homes can be carried back to any taxable year ending on or before the effective date of the credit.

### *Effective Date*

The credit applies to homes whose construction is substantially completed after December 31, 2005, and which are purchased after December 31, 2005.

## 21. Credit for certain nonbusiness energy property (sec. 1333 of the Act and new sec. 25C of the Code)

### *Present Law*

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

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

### *Reasons for Change*

The Congress recognizes that residential energy use for heating and cooling represents a large share of national energy consumption, and accordingly believes that measures to reduce heating and cooling energy requirements have the potential to substantially reduce national energy consumption. The Congress further recognizes that many existing homes are inadequately insulated. Accordingly, the Congress believes that a tax credit for certain energy-efficiency

improvements related to a home's envelope (exterior windows (including skylights) and doors, insulation, and certain roofing systems) will encourage homeowners to improve the insulation of their homes, which in turn will reduce national energy consumption.

### *Explanation of Provision*

The provision provides a 10-percent credit for the purchase of qualified energy efficiency improvements to existing homes for 2006 and 2007. The credit applies to property placed in service after December 31, 2005 and prior to January 1, 2008. A qualified energy efficiency improvement is any energy efficiency building envelope component that meets or exceeds the prescriptive criteria for such a component established by the 2000 International Energy Conservation Code as supplemented and as in effect on the date of enactment (August 8, 2005) (or, in the case of metal roofs with appropriate pigmented coatings, meets the Energy Star program requirements), and (1) that is installed in or on a dwelling located in the United States; (2) owned and used by the taxpayer as the taxpayer's principal residence; (3) the original use of which commences with the taxpayer; and (4) such component reasonably can be expected to remain in use for at least five years. The credit is nonrefundable.

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

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

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

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

Qualified energy-efficient property is: (1) an electric heat pump water heater which yields an energy factor of at least 2.0 in the standard Department of Energy test procedure, (2) an electric heat pump which has a heating seasonal performance factor (HSPF) of at least 9, a seasonal energy efficiency ratio (SEER) of at least 15, and an energy efficiency ratio (EER) of at least 13, (3) a geothermal heat pump which (i) in the case of a closed loop product, has an energy efficiency ratio (EER) of at least 14.1 and a heating coefficient of performance (COP) of at least 3.3, (ii) in the case of an open loop product, has an energy efficiency ratio (EER) of at least 16.2 and a heating coefficient of performance (COP) of at least 3.6,

and (iii) in the case of a direct expansion (DX) product, has an energy efficiency ratio (EER) of at least 15 and a heating coefficient of performance (COP) of at least 3.5, (4) a central air conditioner with energy efficiency of at least the highest efficiency tier established by the Consortium for Energy Efficiency as in effect on Jan. 1, 2006, and (5) a natural gas, propane, or oil water heater which has an energy factor of at least 0.80.

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

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

### *Effective Date*

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

## 22. Credit for energy efficient appliances (sec. 1334 of the Act and new sec. 45M of the Code)

### *Present Law*

There is no present-law credit for the manufacture of energy-efficient appliances.

### *Explanation of Provision*

The provision provides a credit for 2006 and 2007 for the eligible production of certain energy-efficient dishwashers, clothes washers and refrigerators. The credit applies to appliances produced after December 31, 2005 and prior to January 1, 2008.

The credit for dishwashers applies to dishwashers produced in 2006 and 2007 that meet the Energy Star standards for 2007. The credit amount equals $3 multiplied by the percentage by which the efficiency of the 2007 standards exceeds that of the 2005 standards. The credit may not exceed $100 per dishwasher.

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

The credit for refrigerators is based on energy savings and year of manufacture. The energy savings are determined relative to the energy conservation standards promulgated by the Department of Energy that took effect on July 1, 2001. Refrigerators manufactured in 2006 or 2007 (1) receive a $75 credit if they achieve a 15 to 20 percent energy saving, (2) receive a $125 credit if they achieve a 20 to 25 percent energy saving, or (3) receive a $175 credit if they achieve at least a 25 percent energy saving.

Appliances eligible for the credit include only those that exceed the average amount of production from the 3 prior calendar years for each category of appliance. In the case of refrigerators, eligible production is production that exceeds 110 percent of the average amount of production from the 3 prior calendar years. A dishwasher is any a residential dishwasher subject to the energy con-

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

The taxpayer may not claim credits in excess of $75 million for all taxable years, and may not claim credits in excess of $20 million with respect to refrigerators eligible for the $75 credit. Additionally, the credit allowed in a taxable year for all appliances may not exceed two percent of the average annual gross receipts of the taxpayer for the three taxable years preceding the taxable year in which the credit is determined.

The credit is part of the general business credit.

### *Effective Date*

The credit applies to appliances produced after December 31, 2005.

## 23. Credit for residential energy efficient property (sec. 1335 of the Act and new sec. 25D of the Code)

### *Present Law*

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

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

### *Reasons for Change*

The Congress recognizes that residential energy use represents a large share of national energy consumption, and accordingly believes that measures to encourage alternative energy sources for residential use have the potential to substantially reduce national reliance on traditional energy sources. The Congress believes that a tax credit for investments in solar energy sources and fuel cell power plants will help to achieve that goal. Furthermore, the Congress believes that the on-site generation of electricity will reduce the burden on the United States' electricity grid and on natural gas pipelines.

### *Explanation of Provision*[84]

The provision provides a personal tax credit for 2006 and 2007 for the purchase of qualified photovoltaic property and qualified solar water heating property that is used exclusively for purposes other than heating swimming pools and hot tubs. The credit ap-

[84] The provision was subsequently extended and modified in Division A, section 206 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

plies to property placed in service after December 31, 2005 and prior to January 1, 2008. The credit is equal to 30 percent of qualifying expenditures, with a maximum credit for each of these systems of property of $2,000. The provision also provides a 30 percent credit for the purchase of qualified fuel cell power plants. The credit for any fuel cell may not exceed $500 for each 0.5 kilowatt of capacity.

Qualifying solar water heating property means an expenditure for property to heat water for use in a dwelling unit located in the United States and used as a residence if at least half of the energy used by such property for such purpose is derived from the sun. Qualified photovoltaic property is property that uses solar energy to generate electricity for use in a dwelling unit. A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that (1) converts a fuel into electricity using electrochemical means, (2) has an electricity-only generation efficiency of greater than 30 percent, and (3) generates at least 0.5 kilowatts of electricity. The qualified fuel cell power plant must be installed on or in connection with a dwelling unit located in the United States and used by the taxpayer as a principal residence.

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

Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

### *Effective Date*

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

## 24. Credit for business installation of qualified fuel cells and stationary microturbine power plants (sec. 1336 of the Act and sec. 48 of the Code)

### *Present Law*

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

The business energy investment tax credit is a component of the general business credit. The general business credit generally may not exceed the excess of the taxpayer's net income tax over the greater of (1) the tentative minimum tax or (2) 25 percent of net regular tax liability in excess of $25,000. A general business credit

in excess of the tax limitation generally may be carried back one year and carried forward up to 20 years.

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

### *Reasons for Change*

The Congress believes that investments in qualified fuel cell power plants represent a promising means to produce electricity through non-polluting means and from nonconventional energy sources. Furthermore, the on-site generation of electricity provided by fuel cell power plants will reduce reliance on the United States' electricity grid. The Congress believes that providing a tax credit for investment in qualified fuel cell power plants will encourage investments in such systems.

### *Explanation of Provision* [85]

The provision provides a 30 percent business energy credit for the purchase of qualified fuel cell power plants for businesses for 2006 and 2007. A qualified fuel cell power plant is an integrated system composed of a fuel cell stack assembly and associated balance of plant components that (1) converts a fuel into electricity using electrochemical means, (2) has an electricity-only generation efficiency of greater than 30 percent, and (3) generates at least 0.5 kilowatts of electricity. The credit for any fuel cell may not exceed $500 for each 0.5 kilowatts of capacity.

Additionally, the provision provides a 10 percent credit for the purchase of qualifying stationary microturbine power plants. A qualified stationary microturbine power plant is an integrated system comprised of a gas turbine engine, a combustor, a recuperator or regenerator, a generator or alternator, and associated balance of plant components that converts a fuel into electricity and thermal energy. Such system also includes all secondary components located between the existing infrastructure for fuel delivery and the existing infrastructure for power distribution, including equipment and controls for meeting relevant power standards, such as voltage, frequency and power factors. Such system must have an electricity-only generation efficiency of not less that 26 percent at International Standard Organization conditions and a capacity of less than 2,000 kilowatts. The credit is limited to the lesser of 10 percent of the basis of the property or $200 for each kilowatt of capacity.

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

The credit is nonrefundable. The taxpayer's basis in the property is reduced by the amount of the credit claimed.

---

[85] The provision was subsequently extended in Division A, section 207 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

### *Effective Date*

The credit applies to periods after December 31, 2005, for property placed in service in taxable years ending after December 31, 2005, under rules similar to rules of section 48(m) of the Internal Revenue Code of 1986 (as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990).

## 25. Business solar investment tax credit (sec. 1337 of the Act and sec. 48 of the Code)

### *Present Law*

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

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of so much of the net regular tax liability as exceeds $25,000 or (2) the tentative minimum tax. An unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

### *Explanation of Provision*[86]

The provision increases the 10-percent credit to 30 percent in the case of solar energy property. Additionally, the provision provides that equipment that uses fiber-optic distributed sunlight to illuminate the inside of a structure is solar energy property eligible for the 30-percent credit. These two provisions apply for 2006 and 2007. The provision provides that property used to generate energy for the purposes of heating a swimming pool is not eligible solar energy property.

### *Effective Date*

The provision with respect to the heating of swimming pools applies to periods after December 31, 2005. The increase in the credit rate and the provision related to fiber-optic distributed sunlight applies to periods after December 31, 2005, for property placed in service in taxable years ending after December 31, 2005, under rules similar to rules of section 48(m) of the Internal Revenue Code of 1986 (as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990).

---

[86] The provision was subsequently extended in Division A, section 207 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

## 26. Alternative technology vehicle credits (secs. 1341 and 1348 of the Act, sec. 179A of the Code, and new sec. 30B of the Code)

### *Present Law*

Certain costs of qualified clean-fuel vehicle property may be expensed and deducted when such property is placed in service (sec. 179A). Qualified clean-fuel vehicle property includes motor vehicles that use certain clean-burning fuels (natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity and any other fuel at least 85 percent of which is methanol, ethanol, any other alcohol or ether).[87] The maximum amount of the deduction is $50,000 for a truck or van with a gross vehicle weight over 26,000 pounds or a bus with seating capacities of at least 20 adults; $5,000 in the case of a truck or van with a gross vehicle weight between 10,000 and 26,000 pounds; and $2,000 in the case of any other motor vehicle. Qualified electric vehicles do not qualify for the clean-fuel vehicle deduction. The deduction is reduced to 25 percent of the otherwise allowable deduction in 2006 and is unavailable for purchases after December 31, 2006.

### *Reasons for Change*

The Congress believes that automobile transportation in the United States in the 21st century can, and should, be less polluting of the air and more fuel efficient. The Congress recognizes that various technological solutions may lead to this result. The Congress observes that consumer demand is increasing for those hybrid motor vehicles already available in the marketplace. The Congress believes that tax benefits to lower the cost of certain other new automotive technology alternatives can help lower consumer resistance to these technologies and speed the nation's advancement down the highway to cleaner, more efficient, automobiles. The Congress observes that certain diesel technologies offering fuel and environmental benefits are already available in Europe and believes it is important for this technology to be developed for the North American marketplace.

### *Explanation of Provision*

#### *In general*

The provision provides a credit for each new qualified fuel cell vehicle, each new qualified advanced lean burn technology motor vehicle, each new qualified hybrid motor vehicle, and each new qualified alternative fuel motor vehicle placed in service by the taxpayer during the taxable year. The credit is available to vehicles placed in service after December 31, 2005, and, in the case of qualified fuel cell motor vehicles, before January 1, 2015; in the case of qualified hybrid motor vehicles that are automobiles and light trucks and in the case of advanced lean-burn technology vehicles, before January 1, 2011; in the case of qualified hybrid motor vehi-

[87] A hybrid-electric vehicle may qualify as a clean-fuel vehicle under present law. Seven different automobile makes (multiple model years for some makes of automobile) qualify for the present-law deduction.

cles that medium and heavy trucks, before January 1, 2010; and in the case of qualified alternative fuel motor vehicles, before January 1, 2011.

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

***Fuel cell vehicles***

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

**Table 2.—Base Credit Amount for Fuel Cell Vehicles**

| Vehicle gross weight rating in pounds | Credit amount |
|---|---|
| Vehicle ≤ 8,500 | $8,000 |
| 8,500 < vehicle ≤ 14,000 | $10,000 |
| 14,000 < vehicle ≤ 26,000 | $20,000 |
| 26,000 < vehicle | $40,000 |

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

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

**Table 3.—Credit for Qualifying Fuel Cell Vehicles**

| Credit | If fuel economy of the fuel cell vehicle is: | |
|---|---|---|
| | At least | but less than |
| $1,000 | 150% of base fuel economy. | 175% of base fuel economy |
| $1,500 | 175% of base fuel economy. | 200% of base fuel economy |

**Table 3.—Credit for Qualifying Fuel Cell Vehicles**—Continued

| Credit | If fuel economy of the fuel cell vehicle is: | |
|---|---|---|
| | At least | but less than |
| $2,000 ..... | 200% of base fuel economy. | 225% of base fuel economy |
| $2,500 ..... | 225% of base fuel economy. | 250% of base fuel economy |
| $3,000 ..... | 250% of base fuel economy. | 275% of base fuel economy |
| $3,500 ..... | 275% of base fuel economy. | 300% of base fuel economy |
| $4,000 ..... | 300% of base fuel economy | |

***Hybrid vehicles and advanced lean-burn technology vehicles***

*Qualifying hybrid vehicle*

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

***Hybrid vehicles that are automobiles and light trucks***

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

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

**Table 4.—Fuel Economy Credit**

| | If fuel economy of the hybrid vehicle is: | |
|---|---|---|
| | at least | but less than |
| $400 .. | 125% of base fuel economy | 150% of base fuel economy |
| $800 .. | 150% of base fuel economy | 175% of base fuel economy |
| $1,200 | 175% of base fuel economy | 200% of base fuel economy |
| $1,600 | 200% of base fuel economy | 225% of base fuel economy |
| $2,000 | 225% of base fuel economy | 250% of base fuel economy |
| $2,400 | 250% of base fuel economy | |

Table 5, below, shows the conservation credit.

**Table 5.—Conservation Credit**

| Estimated lifetime fuel savings | Conservation amount |
|---|---|
| At least 1,200 but less than 1,800 | $250 |
| At least 1,800 but less than 2,400 | $500 |
| At least 2,400 but less than 3,000 | $750 |
| At least 3,000 | $1,000 |

*Advanced lean-burn technology motor vehicles*

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

A qualifying advanced lean burn technology motor vehicle is a passenger automobile or a light truck that incorporates direct injection, achieves at least 125 percent of the 2002 model year city fuel economy, and for 2004 and later model vehicles meets or exceeds certain Environmental Protection Agency emissions standards. For a vehicle with a gross vehicle weight rating of 6,000 pounds or less the applicable emissions standards are the Bin 5 Tier II emissions standards. For a vehicle with a gross vehicle weight rating greater than 6,000 pounds and less than or equal to 8,500 pounds, the applicable emissions standards are the Bin 8 Tier II emissions standards. A qualifying advanced lean burn technology motor vehicle must be placed in service before January 1, 2011.

*Limitation on number of qualified hybrid and advanced lean-burn technology motor vehicles eligible for the credit*

There is a limitation on the number of qualified hybrid motor vehicles and advanced lean-burn technology motor vehicles sold by each manufacturer of such vehicles that are eligible for the credit.

Taxpayers may claim the full amount of the allowable credit up to the end of the first calendar quarter after the quarter in which the manufacturer records the 60,000th hybrid and advanced lean-burn technology motor vehicle sale occurring after December 31, 2005. Taxpayers may claim one half of the otherwise allowable credit during the two calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale. In the third and fourth calendar quarters subsequent to the first quarter after the manufacturer has recorded its 60,000th such sale, the taxpayer may claim one quarter of the otherwise allowable credit.

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

*Hybrid vehicles that are medium and heavy trucks*

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

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

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

14,000 pounds must have a maximum available power from the rechargeable energy storage system of at least 15 percent.[88]

### *Alternative fuel vehicle*

The credit for the purchase of a new alternative fuel vehicle is 50 percent of the incremental cost of such vehicle, plus an additional 30 percent if the vehicle meets certain emissions standards, but not more than between $4,000 and $32,000 depending upon the weight of the vehicle. To be eligible for the credit, a qualifying alternative fuel vehicle must be purchased before January 1, 2011. Table 6, below, shows the maximum permitted incremental cost for the purpose of calculating the credit for alternative fuel vehicles by vehicle weight class.

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

| Vehicle gross weight rating in pounds | Maximum allowable incremental cost |
|---|---|
| Vehicle ≤ 8,500 | $5,000 |
| 8,500 < vehicle ≤ 14,000 | $10,000 |
| 14,000 < vehicle ≤ 26,000 | $25,000 |
| 26,000 < vehicle | $40,000 |

Alternative fuels comprise compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid fuel that is at least 85 percent methanol. Qualifying alternative fuel motor vehicles are vehicles that operate only on qualifying alternative fuels and are incapable of operating on gasoline or diesel (except in the extent gasoline or diesel fuel is part of a qualified mixed fuel, described below).

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

### *Base fuel economy*

The base fuel economy is the 2002 model year city fuel economy for vehicles by inertia weight class by vehicle type. The "vehicle inertia weight class" is that defined in regulations prescribed by the Environmental Protection Agency for purposes of Title II of the Clean Air Act. Table 7, below, shows the 2002 model year city fuel economy for vehicles by type and by inertia weight class.

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

**Table 7.—2002 Model Year City Fuel Economy**

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

***Other rules***

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

***Termination of Code section 179A***

The provision provides that section 179A sunsets after December 31, 2005.

***Effective Date***

The provision applies to vehicles placed in service after December 31, 2005,

**27. Credit for installation of alternative fuel refueling property (sec. 1342 of the Act and new sec. 30C of the Code)**

***Present Law***

Clean-fuel vehicle refueling property may be expensed and deducted when such property is placed in service (sec. 179A). Clean-fuel vehicle refueling property comprises property for the storage or dispensing of a clean-burning fuel, if the storage or dispensing is the point at which the fuel is delivered into the fuel tank of a motor vehicle. Clean-fuel vehicle refueling property also includes property for the recharging of electric vehicles, but only if the property is located at a point where the electric vehicle is recharged. Up to $100,000 of such property at each location owned by the tax-

payer may be expensed with respect to that location. The deduction is unavailable for costs incurred after December 31, 2006.

For the purpose of sec. 179A clean fuels comprise natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity, and any other fuel at least 85 percent of which is methanol, ethanol, or any other alcohol or ether.

### *Explanation of Provision*

The provision permits taxpayers to claim a 30-percent credit for the cost of installing clean-fuel vehicle refueling property to be used in a trade or business of the taxpayer or installed at the principal residence of the taxpayer. In the case of retail clean-fuel vehicle refueling property the allowable credit may not exceed $30,000. In the case of residential clean-fuel vehicle refueling property the allowable credit may not exceed $1,000. The credit is available for non-hydrogen refueling property from 2006 through 2009 and for hydrogen refueling property from 2006 through 2014.

Under the provision clean fuels are any fuel at least 85 percent of the volume of which consists of ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, and hydrogen and any mixture of diesel fuel and biodiesel containing at least 20 percent biodiesel.

The taxpayer's basis in the property is reduced by the amount of the credit and the taxpayer may not claim deductions under section 179A with respect to property for which the credit is claimed. In the case of refueling property installed on property owned or used by a tax-exempt person, the taxpayer that installs the property may claim the credit. To be eligible for the credit, the property must be placed in service before January 1, 2010, in the case non-hydrogen refueling property and January 1, 2015, in the case of hydrogen refueling property.

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

### *Effective Date*

The provision is effective for property placed in service December 31, 2005.

## 28. Diesel-water fuel emulsion (sec. 1343 of the Act and sec. 4081 of the Code)

### *Present Law*

A 24.3-cents-per-gallon excise tax is imposed on diesel fuel to finance the Highway Trust Fund.[89] Gasoline and most special motor fuels are subject to tax at 18.3 cents per gallon for the Trust Fund.[90]

[89] Sec. 4081(a)(2)(A)(iii).
[90] Secs. 4081(a)(2)(A)(i) and 4041(a)(2)(B)(i).

The tax rate for certain special motor fuels is determined, on an energy equivalent basis, as follows:[91]

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

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

### *Reasons for Change*

Because diesel-water emulsion fuels have fewer British thermal units ("Btu") per gallon, larger quantities must be purchased to travel the same number of miles as regular diesel fuel. A Btu-based tax rate better correlates highway use and tax paid. The Congress further understands that the diesel-water emulsion fuel may reduce emissions of air pollutants relative to regular diesel fuel and believes that the Btu-based rate, by removing a tax disadvantage to use of the fuel, will be beneficial to the environment.

### *Explanation of Provision*

A special tax rate of 19.7 cents per gallon is provided for diesel fuel blended with water into a diesel-water fuel emulsion to reflect the reduced Btu content per gallon resulting from the water. Emulsion fuels eligible for the special rate must consist of not more than 86 percent diesel (and other minor chemical additives to enhance combustion) and at least 14 percent water. The emulsion addition must be registered by a United States manufacturer with the Environmental Protection Agency pursuant to section 211 of the Clean Air Act (as in effect on March 31, 2003). In addition, the person claiming entitlement to the special rate of tax must be registered with the Secretary. A refund of the difference between the regular rate (24.3 cents per gallon) and the incentive rate (19.7 cents per gallon) is available to the extent tax-paid diesel is used to produce a qualifying emulsion diesel fuel. The provision clarifies that claims for refund based on the incentive rate may be filed quarterly if such person can claim at least $750. If the person cannot claim at least $750 at the end of quarter, the amount can be carried over to the next quarter to determine if the person can claim at least $750. If the person cannot claim at least $750 at the end of the taxable year, the person must claim a credit on the person's income tax return.

Anyone who separates the diesel fuel from the diesel-water fuel emulsion on which a reduced rate of tax was imposed is treated as a refiner of the fuel and is liable for the difference between the amount of tax on the latest removal of the separated fuel and the amount of tax that was imposed upon the pre-mixture removal.

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

### *Effective Date*

The provision is effective on January 1, 2006.

## 29. Extend excise tax provisions and income tax credit for biodiesel and create similar incentives for renewable diesel (secs. 1344 and 1346 of the Act, and secs. 40A, 6426 and 6427 of the Code)

### *Present Law*

#### *Biodiesel income tax credit*

*Overview*

The Code provides an income tax credit for biodiesel and qualified biodiesel mixtures, the biodiesel fuels credit.[92] The biodiesel fuels credit is the sum of the biodiesel mixture credit plus the biodiesel credit and is treated as a general business credit. The amount of the biodiesel fuels credit is includable in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions discussed below. The credit may not be carried back to a taxable year ending before or on December 31, 2004. The provision does not apply to fuel sold or used after December 31, 2006.

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

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

*Biodiesel mixture credit*

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

*Biodiesel credit*

The biodiesel credit is 50 cents for each gallon of biodiesel which is not in a mixture with diesel fuel (100 percent biodiesel or B–100)

[92] Sec. 40A.

and which during the taxable year is (1) used by the taxpayer as a fuel in a trade or business or (2) sold by the taxpayer at retail to a person and placed in the fuel tank of such person's vehicle. For agri-biodiesel, the credit is $1.00 per gallon.

***Biodiesel mixture excise tax credit***

The Code also provides an excise tax credit for biodiesel mixtures.[93] The credit is 50 cents for each gallon of biodiesel used by the taxpayer in producing a biodiesel mixture for sale or use in a trade or business of the taxpayer. In the case of agri-biodiesel, the credit is $1.00 per gallon. A biodiesel mixture is a mixture of biodiesel and diesel fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. No credit is allowed unless the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.[94]

The credit is not available for any sale or use for any period after December 31, 2006. This excise tax credit is coordinated with the income tax credit for biodiesel such that credit for the same biodiesel cannot be claimed for both income and excise tax purposes.

***Payments with respect to biodiesel fuel mixtures***

If any person produces a biodiesel fuel mixture in such person's trade or business, the Secretary is to pay such person an amount equal to the biodiesel mixture credit.[95] To the extent the biodiesel fuel mixture credit exceeds the section 4081 liability of a person, the Secretary is to pay such person an amount equal to the biodiesel fuel mixture credit with respect to such mixture.[96] Thus, if the person has no section 4081 liability, the credit is refundable. The payment provision does not apply with respect to biodiesel fuel mixtures sold or used after December 31, 2006.

## *Explanation of Provision*

The provision extends the income tax credit, excise tax credit, and payment provisions through December 31, 2008.

The provision also creates a similar income tax credit, excise tax credit and payment system for renewable diesel; however, there is no credit for small producers of renewable diesel. Renewable diesel means diesel fuel derived from biomass (as defined in section 29(c)(3), thus excluding petroleum oil, natural gas, coal, or any product thereof) using a thermal depolymerization process.[97] Renewable diesel must meet the requirements of the American Society of Testing and Materials D975 or D396, and meet the registration requirements for fuels and fuel additives established by the

[93] Sec. 6426(c).
[94] Sec. 6426(c)(4).
[95] Sec. 6427(e).
[96] Sec. 6427(e)(1) and 6327(e)(2). See also, Internal Revenue Service, Notice 2005–4, 2005–2 I.R.B. 289 (December 15, 2004).
[97] Thermal depolymerization is a process for the reduction of complex organic materials (such as turkey offal) into light crude oil. The process uses pressure and heat to decompose long chain polymers of hydrogen, oxygen, and carbon into short-chain petroleum hydrocarbons with a maximum length of around 18 carbons.

Environmental Protection Agency under section 211 of the Clean Air Act (42 USC 7545). The amount of the credit for renewable diesel is $1.00 per gallon. In addition, all producers of renewable diesel must be registered with the Secretary.

### *Effective Date*

The extension of incentives is effective on the date of enactment. The renewable diesel provisions are effective for fuel sold or used after December 31, 2005.

## 30. Small agri-biodiesel producer credit (sec. 1345 of the Act and sec. 40A of the Code)

### *Present Law*

#### *Biodiesel income tax credit*

The Code provides an income tax credit for biodiesel and qualified biodiesel mixtures, the biodiesel fuels credit. The biodiesel fuels credit is the sum of the biodiesel mixture credit plus the biodiesel credit and is treated as a general business credit. The amount of the biodiesel fuels credit is includable in gross income. The biodiesel fuels credit is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions created by the Act. The credit may not be carried back to a taxable year ending before or on December 31, 2004. The provision does not apply to fuel sold or used after December 31, 2006.

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

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

The biodiesel income tax credit does not contain any incentives for small producers.

#### *Small ethanol producer credit*

Present law provides several tax benefits for ethanol and methanol produced from renewable sources that are used as a motor fuel or that are blended with other fuels (e.g., gasoline) for such a use. In the case of ethanol, a separate 10-cents-per-gallon credit for up to 15 million gallons per year for small producers, defined generally as persons whose production does not exceed 15 million gallons per year and whose production capacity does not exceed 30 million gallons per year. The ethanol must (1) be sold by such producer to another person (a) for use by such other person in the production of al qualified alcohol fuel mixture in such person's trade or business (other than casual off-farm production), (b) for use by

such other person as a fuel in a trade or business, or, (c) who sells such ethanol at retail to another person and places such ethanol in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c). A cooperative may pass through the small ethanol producer credit to its patrons. The alcohol fuels tax credits are includible in income. This credit may be used to offset alternative minimum tax liability. The credit is a treated as a general business credit, subject to the ordering rules and carryforward/carryback rules that apply to business credits generally. The alcohol fuels tax credit is scheduled to expire after December 31, 2010.

### *Explanation of Provision*

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

Like the small ethanol producer credit, cooperatives may elect to pass through any portion of the small agri-biodiesel producer credit to its patrons. The credit is apportioned pro rata among patrons of the cooperative on the basis of the quantity or value of the business done with or for such patrons for the taxable year. An election to pass through the credit is made on a timely filed return for the taxable year and, once made, is irrevocable for such taxable year.

The amount of the credit not apportioned to patrons is included in the organization's credit for the taxable year of the organization. The amount of the credit apportioned to patrons is to be included in the patron's credit for the first taxable year of each patron ending on or after the last day of the payment period for the taxable year of the organization, or, if earlier, for the taxable year of each patron ending on or after the date on which the patron receives notice from the cooperative of the apportionment.

If the amount of the cooperative's credit for a taxable year is less than the amount of the credit shown on the organization's tax return for such taxable year, an amount equal to the excess of the reduction in the credit over the amount not apportioned to patrons for the taxable year is treated as an increase in the cooperative's tax. The increase is not treated as tax imposed for purposes of determining the amount of any tax credit or for purposes of the alternative minimum tax.

The small producer credit sunsets after December 31, 2008, along with the other biodiesel incentives.

### *Effective Date*

The provision is effective for taxable years ending after the date of enactment (August 8, 2005).

## 31. Modifications to small ethanol producer credit (sec. 1347 of the Act and sec. 40 of the Code)

### *Present Law*

Present law provides several tax benefits for ethanol and methanol that are used as a fuel or that are blended with other fuels (e.g., gasoline) for such a use. For example, the Code provides an income tax credit for alcohol and alcohol-blended fuels. In the case of ethanol, the Code provides an additional 10-cents-per-gallon credit for small producers, defined generally as persons whose production capacity does not exceed 30 million gallons per year.[98]

### *Explanation of Provision*

The provision increases the limit on production capacity for small ethanol producers from 30 million gallons to 60 million gallons per year.

The provision also provides that an election to pass the small ethanol producer credit through to cooperative patrons is not valid unless the cooperative provides patrons timely written notice of the apportionment of the credit. Under the provision, notice is timely if mailed to patrons during the payment period described in section 1382(d) of the Code.

### *Effective Date*

The provision is effective for taxable years ending after the date of enactment (August 8, 2005).

## 32. Modify research credit for research relating to energy (sec. 1351 of the Act and sec. 41 of the Code)

### *Present Law*

#### *General rule*

Section 41 provides for a research tax 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 tax credit is scheduled to expire and generally will not apply to amounts paid or incurred after December 31, 2005.

A 20-percent research tax 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 computa-

[98] Sec. 40(b)(4) and (g)(1). The alcohol fuels tax credit (which is comprised of the small ethanol producer credit, the alcohol mixture credit, and the alcohol credit) is scheduled to expire after December 31, 2010 (sec. 40(e)(1)).

tion is commonly referred to as the university basic research credit (see sec. 41(e)).

***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 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 tax 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). In the case of amounts paid to a research consortium, 75 percent of amounts paid for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 for the deduction for research expenses, 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.

### *Explanation of Provision*[99]

The provision modifies the present-law research credit as it applies to qualified energy research. In particular, the provision provides that the taxpayer may claim a credit equal to 20 percent of the taxpayer's expenditures on qualified energy research undertaken by an energy research consortium. The amount of credit claimed is determined only by regard to such expenditures by the taxpayer within the taxable year. Unlike the general rule for the research credit, the 20-percent credit for research by an energy research consortium applies to all such expenditures, not only those in excess of a base amount however determined. An energy research consortium is a qualified research consortium as under present law that also is organized and operated primarily to conduct energy research and development in the public interest and to which at least five unrelated persons paid, or incurred amounts, to such organization within the calendar year. In addition, to be a qualified energy research consortium no single person shall pay or incur more than 50 percent of the total amounts received by the research consortium during the calendar year.

The provision also provides that 100 percent of amounts paid or incurred by the taxpayer to eligible small businesses, universities, and Federal laboratories for qualified energy research would constitute qualified research expenses as contract research expenses, rather than 65 percent of qualified research expenditures allowed under present law. An eligible small business for this purpose is a business in which the taxpayer does not own a 50 percent or greater interest and the business has employed, on average, 500 or fewer employees in the two preceding calendar years.

Qualified energy research expenditures are expenditures that would otherwise qualify for the research credit under present law and relate to the production, supply, and conservation of energy, including otherwise qualifying research expenditures related to alternative energy sources or the use of alternative energy sources. For example, research relating to hydrogen fuel cell vehicles would qualify under this provision, if the research expenditures otherwise satisfy the criteria of present-law sec. 41. Likewise, otherwise qualifying research undertaken to improve the energy-efficiency of lighting would qualify under this provision.

### *Effective Date*

The provision is effective for amounts paid or incurred after the date of enactment in taxable years ending after such date.

## 33. National Academy of Sciences study (sec. 1352 of the Act)

### *Present Law*

Present law does not provide for a study of the health, environmental, security, and infrastructure external costs that may be associated with the use and production of energy.

[99] The provision was subsequently modified in Division A, section 104 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

### *Explanation of Provision*

The provision requires the Secretary of Treasury to enter into an agreement, within 60 days, with the National Academy of Sciences to conduct a study to define and evaluate the health, environmental, security, and infrastructure external costs and benefits associated with production and consumption of energy that are not or may not be fully incorporated into the price of such activities, or into the Federal tax or fee or other applicable revenue measure related to such activities. The results of the study are to be submitted to Congress within two years of the agreement.

### *Effective Date*

The provision is effective on the date of enactment (August 8, 2005).

## 34. Recycling study (sec. 1353 of the Act)

### *Present Law*

Present law does not provide for a study to determine and quantify the energy savings achieved through the recycling of glass, paper, plastic, steel, aluminum, and electronic devices, not to identify tax incentives which would encourage recycling of such material.

### *Explanation of Provision*

The provision directs the Secretary of the Treasury, in consultation with the Secretary of Energy, to conduct a study to determine and quantify the energy savings achieved through the recycling of glass, paper, plastic, steel, aluminum, and electronic devices, and to identify tax incentives that would encourage recycling of such material. The study is to be submitted to Congress within one year of the date of enactment (August 8, 2005).

### *Effective Date*

The provision is effective on the date of enactment (August 8, 2005).

## 35. Oil Spill Liability Trust Fund (sec. 1361 of the Act and sec. 4611 of the Code)

### *Present Law*

Between December 31, 1989, and January 1, 1995, a five-cent-per-barrel tax was imposed on crude oil received at a United States refinery and imported petroleum products received for consumption, use, or warehousing, and any domestically produced crude oil that is exported from the United States if, before exportation, no taxes were imposed on the crude oil. The tax was effective only if the unobligated balance in the Fund was less than $1 billion. Taxes received were credited to the Oil Spill Liability Trust Fund. The Oil Spill Liability Trust Fund is used for several purposes, includ-

ing the payment of costs for responding to and removing oil spills.[100]

### *Explanation of Provision*

The provision reinstates the Oil Spill Liability Trust Fund tax. The tax applies on April 1, 2006, or if later, the last day of any calendar quarter for which the Secretary estimates that, as of the close of that quarter, the unobligated balance in the Oil Spill Liability Trust Fund is less than $2 billion.

The tax will be suspended during a calendar quarter if the Secretary estimates that, as of the close of the preceding calendar quarter, the unobligated balance in the Oil Spill Liability Trust Fund exceeds $2.7 billion. The tax terminates after December 31, 2014.

### *Effective Date*

The provision is effective on the date of enactment (August 8, 2005).

## 36. Leaking Underground Storage Tank Trust Fund (sec. 1362 of the Act and secs. 4041, 4081(d), 4082, 9508, and new sec. 6430 of the Code)

### *Present Law*

The Code imposes an excise tax, generally at a rate of 0.1 cents per gallon, on gasoline, diesel, kerosene, and special motor fuels (other than liquefied petroleum gas and liquefied natural gas).[101] The taxes are deposited in the Leaking Underground Storage Tank ("LUST") Trust Fund. The tax expires on October 1, 2005.

Diesel fuel and kerosene that is to be used for a nontaxable purpose will not be taxed upon removal from the terminal if it is dyed to indicate its nontaxable purpose.

The Code requires the LUST Trust Fund to reimburse the General Fund for certain refund and credit claims related to the nontaxable use of fuel (only to the extent attributable to the LUST Trust fund financing rate).[102]

### *Explanation of Provision*

Under the provision, the LUST Trust Fund tax is extended at the current rate through September 30, 2011. Further, all fuel, including dyed fuel, is subject to the LUST tax and no refund or claim for payment in the case of otherwise nontaxable use (other than exports) is permitted for such fuel. Under the Act, the LUST

---

[100] Sec. 9509(c)(1).

[101] For qualified methanol and ethanol fuel the rate is 0.05 cents per gallon (sec. 4041(b)(2)(A)(ii)). Qualified methanol or ethanol fuel is any liquid at least 85 percent of which consists of methanol, ethanol or other alcohol produced from coal (including peat) (sec. 4041(b)(2)(B)).

[102] Specifically, section 9508(c)(2) requires the LUST Trust Fund to reimburse the General Fund from time to time for claims paid pursuant to sections 6420 (relating to amounts paid in respect of gasoline used on farms), section 6421 (relating to amounts paid in respect of gasoline used for certain nonhighway purposes or by local transit systems), and section 6427 (relating to fuels not used for taxable purposes) and income tax credits allowed under section 34 for the purposes previously mentioned. No income tax credit is allowed for any amount payable under section 6421 or 6427 if a claim for such amount is timely filed and is payable under such section (sec. 34(b)).

Trust Fund is no longer required to reimburse the General Fund for claims and credits related to the nontaxable use of fuel.

### *Effective Date*

The provision is generally effective for fuel entered, removed or sold after September 30, 2005. The extension of the trust fund tax is effective October 1, 2005.

## 37. Modify recapture of section 197 amortization (sec. 1363 of the Act and sec. 1245 of the Code)

### *Present Law*

Taxpayers are entitled to recover the cost of amortizable section 197 intangibles using the straight-line method of amortization over a uniform life of fifteen years.[103] With certain exceptions, amortizable section 197 intangibles generally are purchased intangibles held by a taxpayer in the conduct of a business.[104]

Gain on the sale of depreciable property must be recaptured as ordinary income to the extent of depreciation deductions previously claimed,[105] and the recapture amount is computed separately for each item of property. Section 197 intangibles, because they are treated as property of a character subject to the allowance for depreciation,[106] are subject to these recapture rules.

### *Explanation of Provision*

Under the provision, if multiple section 197 intangibles are sold (or otherwise disposed of) in a single transaction or series of transactions, the seller must calculate recapture as if all of the section 197 intangibles were a single asset. Thus, any gain on the sale (or other disposition) of the intangibles is recaptured as ordinary income to the extent of ordinary depreciation deductions previously claimed on any of the section 197 intangibles.

The following example illustrates present law and the provision:

*Example.*—In year 1, a taxpayer acquires two section 197 intangible assets for a total of $45. Asset A is assigned a cost basis of $15 and asset B is assigned a cost basis of $30. The allocation is irrelevant for amortization purposes, as the taxpayer will be entitled to a total of $3 per year ($45 divided by 15 years).

In year 6, the basis of A is $10 and the basis of B is $20. Taxpayer sells the assets for an aggregate sale price of $45, resulting in gain of $15. The character of this gain depends on the recapture amount, which depends in turn on the relative sales prices of the individual assets. Taxpayer has claimed $5 of amortization, and therefore has $5 of recapture potential, with respect to A. Taxpayer has claimed $10 of amortization, and therefore has $10 of recapture potential, with respect to B.

Under present law, if the sale proceeds are allocated $15 to A and $30 to B, the gain on assets A and B will be $5 and $10, respectively. These amounts match the recapture potential for each

[103] Sec. 197(a)
[104] Sec. 197(c)
[105] Sec. 1245.
[106] Sec. 197(f)(7).

asset, so the full amount of the gain will be recaptured as ordinary income. However, if the sale proceeds instead are allocated $25 to A and $20 to B, the full $15 gain will be recognized with respect to A, and only $5 (full recapture potential with respect to A) will be recaptured as ordinary income. The remaining $10 of gain attributable to A will be treated as capital gain. No gain (and thus no recapture) will be recognized with respect to Asset B, and only $5 of the $15 recapture potential is recognized.

Under the Act, the taxpayer calculates recapture as if assets A and B were a single asset. For purposes of the calculation, the proceeds are $45 and the gain is $15. Because a total of $15 of amortization has been claimed with respect to assets A and B, the full $15 gain is recaptured as ordinary income.

### *Effective Date*

The provision is effective for dispositions of property after the date of enactment (August 8, 2005).

## 38. Clarification of tire excise tax (sec. 1364 of the Act and sec. 4072(e) of the Code)

### *Present Law*

The Code imposes an excise tax on highway tires with a rated load capacity exceeding 3,500 pounds, generally at a rate of 9.45 cents per 10 pounds of excess. Biasply tires and super single tires are taxed at a rate of 4.725 cents for each 10 pounds of rated load capacity exceeding 3,500 pounds. A super single tire is a single tire greater than 13 inches in cross section width designed to replace two tires in a dual fitment.

### *Explanation of Provision*

The provision clarifies that the definition of super single tire does not include tires designed to serve as steering tires. It is understood that steering axles are not equipped with a dual fitment. Therefore, tires classified as steering tires are not "designed to replace two tires in a dual fitment." To the extent there is any perceived ambiguity in the present law definition, the provision clarifies that steering tires are not included within the definition of super single tire eligible for the special rate of tax. Under the provision, a "super single tire" is a single tire greater than 13 inches in cross section width designed to replace two tires in a dual fitment, but such term does not include any tire designed for steering.

With respect to the one-year period beginning on January 1, 2006, the IRS is required to report to the Congress on the amount of tax collected during such period for each class of taxable tire (e.g. biasply, super single, or other) and the number of tires in each such class on which tax is imposed during such period. The report must be submitted no later than July 1, 2007. The IRS is directed to revise the Form 720, Quarterly Federal Excise Tax Return, to collect the information necessary to prepare the report. The report is also to include total tire tax collections for an equivalent one-

year period preceding the date of enactment of the American Jobs Creation Act of 2004.

### *Effective Date*

The provision regarding the definition of a super single tire is effective as if included in section 869 of the American Jobs Creation Act of 2004. The study requirement is effective on the date of enactment (August 8, 2005).

# PART SIX: SAFE, ACCOUNTABLE, FLEXIBLE, EFFICIENT TRANSPORTATION EQUITY ACT: A LEGACY FOR USERS (PUBLIC LAW 109–59) [107]

## TITLE XI—HIGHWAY REAUTHORIZATION AND EXCISE TAX SIMPLIFICATION

## I. TRUST FUND REAUTHORIZATION

### A. Extension of Highway Trust Fund and Aquatic Resources Trust Fund Expenditure Authority and Related Taxes (secs. 11101 and 11102 of the Act, and secs. 4041, 4051, 4071, 4081, 4221, 4481, 4482, 4483, 6412, 9503, and 9504 of the Code)

#### *Present-Law Highway Trust Fund Excise Taxes*

#### *In general*

Six separate excise taxes are imposed to finance the Federal Highway Trust Fund program. Three of these taxes are imposed on highway motor fuels. Historically, fuel taxes have accounted for 90 percent of Highway Trust Fund receipts. The remaining three are a retail sales tax on heavy highway vehicles, a manufacturers' excise tax on heavy vehicle tires, and an annual use tax on heavy vehicles. The six taxes are summarized below. Except for 4.3 cents per gallon of the Highway Trust Fund fuels tax rates, and a portion of the tax on certain special motor fuels, all of these taxes, with the exception of the heavy vehicle use tax, are scheduled to expire after September 30, 2005.[108] The 4.3-cents-per-gallon portion of the fuels tax rates is permanent.[109] The six taxes are summarized below.

#### *Highway motor fuels taxes*

The Highway Trust Fund motor fuels tax rates are as follows:[110]

| | |
|---|---|
| Gasoline | 18.3 cents per gallon. |
| Diesel fuel (including transmix) and kerosene | 24.3 cents per gallon. |

[107] H.R. 3. The House Committee on Ways and Means reported H.R. 996 on March 8, 2005 (H.R. Rep. No. 109–13). The text of H.R. 996 was added to H.R. 3 at title X. The House passed H.R. 3 on March 10, 2005. The Senate Committee on Finance reported S. 1230 on June 14, 2005 (S. Rep. No. 109–82). The text of that bill as modified was added as title V of H.R. 3. The Senate passed H.R. 3 with an amendment on May 17, 2005. The conference report was filed on July 28, 2005 (H.R. Rep. No. 109–203) and was passed by the House on July 29, 2005, and the Senate on July 29, 2005. The President signed the bill on August 10, 2005.

[108] The heavy vehicle use tax expires after September 30, 2006. Sec. 4481(f).

[109] This portion of the tax rates was enacted as a deficit reduction measure in 1993. Receipts from it were retained in the General Fund until 1997 legislation provided for their transfer to the Highway Trust Fund.

[110] These fuels also are subject to an additional 0.1-cent-per-gallon excise tax to fund the Leaking Underground Storage Tank ("LUST") Trust Fund (secs. 4041(d) and 4081(a)(2)(B)).

| | |
|---|---|
| Special motor fuels ..... | 18.3 cents per gallon, generally.[111] |

*Exemptions*

Present law includes numerous exemptions (including partial exemptions) for specified uses of taxable fuels or for specified fuels. Because the gasoline and diesel fuel taxes generally are imposed before the end use of the fuel is known, many exemptions are realized through refunds to end users of tax paid by a taxpayer earlier in the distribution chain. Exempt uses and fuels include:

- use in State and local government and nonprofit educational organization highway vehicles;
- use in buses engaged in transporting students and employees of schools;
- use in local mass transit buses having a seating capacity of at least 20 adults (not including the driver) when the buses operate under contract with (or are subsidized by) a State or local governmental unit to furnish the transportation; and
- use in intercity buses serving the general public along scheduled routes. (Such use is totally exempt from the gasoline excise tax and is exempt from 17 cents per gallon of the diesel fuel tax.)

In addition, fuels used in off-highway business use or on a farm for farming purposes generally are exempt from these motor fuels taxes.[112] The Highway Trust Fund does not receive excise taxes imposed on fuel used in off-highway activities. Rather, when tax is imposed on off-highway use fuel consumption, it is used to finance other Trust Funds (e.g., motorboat gasoline and special motor fuel taxes from non-business off-highway use dedicated to the Aquatic Resources Trust Fund) or is retained in the General Fund (e.g., tax on diesel fuel used in trains).

### *Non-fuel Highway Trust Fund excise taxes*

In addition to the highway motor fuels excise tax revenues, the Highway Trust Fund receives revenues produced by three excise taxes imposed exclusively on heavy highway vehicles or tires. These taxes are:

- 12-percent excise tax imposed on the first retail sale of heavy highway vehicles, tractors, and trailers (generally, trucks having a gross vehicle weight in excess of 33,000 pounds and trailers having such a weight in excess of 26,000 pounds) (sec. 4051);

---

[111] The statutory rate for certain special motor fuels is determined on an energy equivalent basis, as follows:

Liquefied petroleum gas (propane): 13.6 cents per gallon. (3.2 cents after September 30, 2005).

Liquefied natural gas: 11.9 cents per gallon. (2.8 cents after September 30, 2005).

Methanol derived from natural gas: 9.15 cents per gallon. (2.15 cents after September 30, 2005).

Compressed natural gas: 48.54 cents per MCF.

See secs. 4041(a)(2), 4041(a)(3) and 4041(m).

The compressed natural gas tax rate is equivalent only to 4.3 cents per gallon of the rate imposed on gasoline and other special motor fuels rather than the full 18.3-cents-per-gallon rate. The tax rate for the other special motor fuels is equivalent to the full 18.3-cents-per-gallon gasoline and special motor fuels tax rate.

[112] Diesel fuel is the same fuel (#2 fuel oil) as that commonly used as home heating oil. Fuel oil used as heating oil is not subject to the Federal excise tax.

- an excise tax imposed on highway tires with a rated load capacity exceeding 3,500 pounds, generally at a rate of 9.45 cents per 10 pounds of excess (sec. 4071(a)); and
- an annual use tax imposed on highway vehicles having a taxable gross weight of 55,000 pounds or more (sec. 4481). (The maximum rate for this tax is $550 per year, imposed on vehicles having a taxable gross weight over 75,000 pounds.)

### *Present-Law Highway Trust Fund Expenditure Provisions*

#### *In general*

Dedication of excise tax revenues to the Highway Trust Fund and expenditures from the Highway Trust Fund are governed by provisions of the Code.[113] The Code authorizes expenditures (subject to appropriations) from the Highway Trust Fund through July 30, 2005, for the purposes provided in authorizing legislation, as in effect on the date of enactment of the Surface Transportation Extension Act of 2005, Part V.[114]

Under present law, revenues from the highway excise taxes generally are dedicated to the Highway Trust Fund. However, under section 9503(c)(2), certain transfers are made from the Highway Trust Fund into the General Fund, relating to amounts paid in respect of gasoline used on farms, amounts paid in respect of gasoline used for certain nonhighway purposes or by local transit systems, amounts relating to fuels not used for taxable purposes, and income tax credits for certain uses of fuels.

#### *Highway Trust Fund expenditure purposes*

The Highway Trust Fund has a subaccount for Mass Transit. Both the Trust Fund and its sub-account are funding sources for specific programs. Neither the Highway Trust Fund nor its Mass Transit sub-account receive interest on unexpended balances. The Highway Fund's Mass Transit sub-account receives 2.86 cents per gallon of highway motor fuels excise taxes.

Highway Trust Fund expenditure purposes have been revised with each authorization Act enacted since establishment of the Highway Trust Fund in 1956. In general, expenditures authorized under those Acts (as the Acts were in effect on the date of enactment of the most recent such authorizing Act) are approved by the Code as Highway Trust Fund expenditure purposes.[115] Thus, no Highway Trust Fund monies may be spent for a purpose not approved by the tax-writing committees of Congress. The Code provides that authority to make expenditures from the Highway Trust

[113] Sec. 9503. The Highway Trust Fund statutory provisions were placed in the Internal Revenue Code in 1982.

[114] The expenditure authority was later extended by Pub. L. No. 109–42, the "Surface Transportation Extension Act of 2005, Part VI", signed into law by the President on July 30, 2005.

[115] The authorizing Acts which currently are referenced in the Highway Trust Fund provisions of the Code are: the Highway Revenue Act of 1956; Titles I and II of the Surface Transportation Assistance Act of 1982; the Surface Transportation and Uniform Relocation Act of 1987; the Intermodal Surface Transportation Efficiency Act of 1991; and the Transportation Equity Act for the 21st Century; the Surface Transportation Extension Act of 2003; the Surface Transportation Extension Act of 2004; the Surface Transportation Extension Act of 2004 Part II; the Surface Transportation Extension Act of 2004, Part III; the Surface Transportation Extension Act of 2004, Part IV; the Surface Transportation Extension Act of 2004, Part V; the Surface Transportation Extension Act of 2005; the Surface Transportation Extension Act of 2005, Part II; the Surface Transportation Extension Act of 2005, Part III; the Surface Transportation Extension Act of 2005, Part IV; and the Surface Transportation Extension Act of 2005, Part V.

Fund expires after July 30, 2005. Thus, no Highway Trust Fund expenditures may occur after July 30, 2005.[116]

### *Anti-deficit provisions (the "Harry Byrd rule")*

Highway projects can take multiple years to complete. As a result, the Highway Trust Fund carries positive unexpended balances, a large portion of which are reserved to cover existing obligations.[117] Highway Trust Fund spending is limited by anti-deficit provisions internal to the Highway Trust Fund, the so-called "Harry Byrd rule." Generally, the Harry Byrd rule prevents the further obligation of Federal highway funds if the current and expected balances of the Highway Trust Fund fall below a certain level. The rule requires the Treasury Department to determine, on a quarterly basis, the amount (if any) by which unfunded highway authorizations exceed projected net Highway Trust Fund tax receipts for the 24-month period beginning at the close of each fiscal year.[118] Similar rules apply to unfunded Mass Transit Account authorizations. If unfunded authorizations exceed projected 24-month receipts, apportionments to the States for specified programs funded by the relevant Trust Fund Account are to be reduced proportionately. Because of the Harry Byrd rule, taxes dedicated to the Highway Trust Fund typically are scheduled to expire at least 24 months after current authorizing Acts.

The Surface Transportation Extension Act of 2003, created a temporary rule (through February 29, 2004) for purposes of the anti-deficit provisions of the Highway Trust Fund. For purposes of determining 24 months of projected revenues for the anti-deficit provisions, the Secretary of the Treasury is instructed to treat each expiring provision relating to appropriations and transfers to the Highway Trust Fund to have been extended through the end of the 24-month period and to assume that the rate of tax during such 24-month period remains at the same rate in effect on the date of enactment of the provision. The temporary rule has been continuously extended since February 29, 2004.[119]

### *Limitations on transfers to the Highway Trust Fund*

The Code also contains a special enforcement provision to prevent expenditure of Highway Trust Fund monies for purposes not authorized in section 9503.[120] Should such unapproved expenditures occur, no further excise tax receipts will be transferred to the Highway Trust Fund. Rather, the taxes will continue to be imposed with receipts being retained in the General Fund. This enforcement provision provides specifically that it applies not only to unauthorized expenditures under the current Code provisions, but also to expenditures pursuant to future legislation that does not amend section 9503's expenditure authorization provisions or otherwise authorize the expenditure as part of a revenue Act.

---

[116] The expenditure authority was later extended by Pub. L. No. 109–42, the "Surface Transportation Extension Act of 2005, Part VI", signed into law by the President on July 30, 2005.

[117] Congressional Research Service, RL 32226, *Highway and Transit Program Reauthorization Legislation in the 2nd Session, 108th Congress* (December 15, 2004) at CRS–12.

[118] Sec. 9503(d).

[119] *See,* Part Four: Surface Transportation Act of 2005, Parts I–VI, *supra*.

[120] Sec. 9503(b)(6).

### *Interrelationship of the Highway Trust Fund and the Aquatic Resources Trust Fund*

The Aquatic Resources Trust Fund is funded by a portion of the receipts from the excise taxes imposed on motorboat gasoline and special motor fuels and on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment. A portion of these taxes are transferred into the Highway Trust Fund and then retransferred into the Aquatic Resources Trust Fund. As a result, transfers to the Aquatic Resources Trust Fund are governed in part by Highway Trust Fund provisions.[121]

A total tax rate of 18.4 cents per gallon is imposed on gasoline and special motor fuels used in motorboats and on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment. Of this rate, 0.1 cent per gallon is dedicated to the Leaking Underground Storage Tank Trust Fund. Of the remaining 18.3 cents per gallon, 4.8 cents per gallon are retained in the General Fund. The balance of 13.5 cents per gallon is transferred to the Highway Trust Fund and then retransferred to the Aquatic Resources Trust Fund and the Land and Water Conservation Fund, as follows.

The Aquatic Resources Trust Fund is comprised of two accounts, the Boat Safety Account and the Sport Fish Restoration Account. Motorboat fuel taxes, not exceeding $70 million per year, are transferred to the Boat Safety Account. In addition, these transfers are subject to an overall annual limit equal to an amount that will not cause the Boat Safety Account to have an unobligated balance in excess of $70 million. To the extent there are excess motorboat fuel taxes, the next $1 million per year of motorboat fuel taxes is transferred from the Highway Trust Fund to the Land and Water Conservation Fund provided for in Title I of the Land and Water Conservation Fund Act of 1965. The balance of the motorboat fuel taxes in the Highway Trust Fund is transferred to the Sport Fish Restoration Account.

The Sport Fish Restoration Account also receives 13.5 cents per gallon of the small-engine fuel taxes from the Highway Trust Fund. This Account is also funded with receipts from an ad valorem manufacturers' excise tax on sport fishing equipment.

The retention in the General Fund of 4.8 cents per gallon of taxes on fuel used in motorboats and in the nonbusiness use of small-engine outdoor power equipment expires with respect to taxes imposed after September 30, 2005.

The expenditure authority for the Aquatic Resources Trust Fund expires after July 30, 2005.[122]

### *Reasons for Change*

The Congress believes that highway and transit spending sustains and creates jobs, providing valuable new opportunities in communities where the availability of jobs is declining. In addition, a long-term reauthorization provides stability for State transportation programs dependent on Federal funds. Thus, the Congress

[121] Secs. 9503(c)(4) and 9503(c)(5).

[122] The expenditure authority was later extended by Pub. L. No. 109–42, the "Surface Transportation Extension Act of 2005, Part VI", signed into law by the President on July 30, 2005.

believes it is appropriate to reauthorize Highway Trust Fund expenditures through September 30, 2009 in coordination with new transportation legislation and to extend current Federal taxes payable to the Highway Trust Fund through September 30, 2011.

The Congress also believes that the full amount of excise taxes imposed on fuel used in motorboats and in the nonbusiness use of small-engine outdoor power equipment should not be retained in the General Fund and should instead be credited to the trust fund dedicated to the users who primarily bear such taxes. Fuel taxes imposed with respect to other uses are currently either dedicated to an appropriate fund or are being phased out. Therefore, the Congress believes that allowing the present-law General Fund retention of such taxes to expire as scheduled is consistent with the treatment of other fuel taxes.

The provision modifies the Harry Byrd rule to require that Highway Account and Mass Transit Account (each separately) unpaid authorizations at the end of a fiscal year be less than or equal to the cash balance of the account at the end of the year plus the projected receipts for the next 48 months, rather than 24 months. Most highway projects are capital projects on which money is spent over a number of years. Given that highway projects, and therefore contract payments, may extend longer than 24 months, the Congress believes it is appropriate to extend the testing period to 48 months to better reflect that some existing obligations will be satisfied by using future tax receipts.

### *Explanation of Provision*

The expenditure authority for the Highway Trust Fund and Aquatic Resources Trust Fund is extended through September 29, 2009 (after September 30, 2009, in the case of expenditures for administrative purposes, and expenditures from the Mass Transit Account).

The Code provisions governing the purposes for which monies in the Highway Trust Fund may be spent are modified to include the new transportation legislation (Pub. L. 109–59). The provision also extends the motor fuel taxes and all three non-fuel excise taxes at their current rates through September 30, 2011.

The provision also changes the Harry Byrd rule from a 24-month to a 48-month receipt rule. Under the provision, the Harry Byrd rule is not triggered unless unfunded highway authorizations exceed projected net Highway Trust Fund tax receipts for the 48-month period beginning at the close of each fiscal year. For purposes of the 48-month rule, taxes are assumed extended beyond their expiration date.

The provision does not extend the General Fund retention of taxes on fuel used in motorboats and in the nonbusiness use of small-engine outdoor power equipment.

### *Effective Date*

The provisions are effective on the date of enactment (August 10, 2005).

## II. EXCISE TAX REFORM AND SIMPLIFICATION

### A. Highway Excise Taxes

### 1. Modify gas guzzler tax (sec. 11111 of the Act and sec. 4064 of the Code)

#### *Present Law*

Under present law, the Code imposes a tax ("the gas guzzler tax") on automobiles that are manufactured primarily for use on public streets, roads, and highways and that are rated at 6,000 pounds unloaded gross vehicle weight or less.[123] The tax applies to limousines without regard to the weight requirement. The tax is imposed on the sale by the manufacturer of each automobile of a model type with a fuel economy of 22.5 miles per gallon or less. The tax range begins at $1,000 and increases to $7,700 for models with a fuel economy less than 12.5 miles per gallon.

Emergency vehicles and non-passenger automobiles are exempt from the tax. The Secretary of Transportation determines which vehicles are "non-passenger" automobiles, thereby exempting these vehicles from the gas guzzler tax based on regulations in effect on the date of enactment of the gas guzzler tax.[124] Hence, vehicles defined in Title 49 C.F.R. sec. 523.5 (relating to light trucks) are exempt. These vehicles include those designed to transport property on an open bed (e.g., pick-up trucks) or provide greater cargo-carrying than passenger carrying volume including the expanded cargo-carrying space created through the removal of readily detachable seats (e.g., pick-up trucks, vans, and most minivans, sports utility vehicles and station wagons). Additional vehicles that meet the "non-passenger" requirements are those with at least four of the following characteristics: (1) an angle of approach of not less than 28 degrees; (2) a breakover angle of not less than 14 degrees; (3) a departure angle of not less than 20 degrees; (4) a running clearance of not less than 20 centimeters; and (5) front and rear axle clearances of not less than 18 centimeters each. These vehicles would include many sports utility vehicles.

#### *Reasons for Change*

The Congress observes that limousines are the only class of vehicles weighing in excess of 6,000 pounds subject to the gas guzzler tax. The Congress believes that, as equipment essential to a commercial enterprise, the present-law application of the gas guzzler tax to such limousines is inappropriate.

---

[123] Sec. 4064.
[124] Sec. 4064(b)(1)(B).

### *Explanation of Provision*

The provision repeals the tax as it applies to limousines rated at greater than 6,000 pounds unloaded gross vehicle weight.

### *Effective Date*

The provision is effective on October 1, 2005.

## 2. Exclusion for tractors weighing 19,500 pounds or less from excise tax on heavy trucks and trailers (sec. 11112 of the Act and sec. 4051 of the Code)

### *Present Law*

A 12-percent excise tax is imposed on the first retail sale of automobile truck chassis and bodies, truck trailer and semitrailer chassis and bodies, and tractors of the kind chiefly used for highway transportation in combination with a trailer or semitrailer.[125] The tax does not apply to automobile truck chassis and bodies suitable for use with a vehicle which has a gross vehicle weight of 33,000 pounds or less.[126] The tax also does not apply to truck trailer and semitrailer chassis and bodies suitable for use with a trailer or semitrailer which has a gross vehicle weight of 26,000 pounds or less.[127] In general, tractors are subject to tax regardless of their gross vehicle weight.

Temporary Treasury regulations provide that "tractor" means a highway vehicle which is primarily designed to tow a vehicle, such as a trailer or semitrailer, but which does not carry cargo on the same chassis as the engine. The regulations presume that a vehicle equipped with air brakes and/or towing package is primarily designed as a tractor.[128] The regulations further require an incomplete chassis cab to be treated as a tractor if it is equipped with any of the safety devices listed in the regulations, and require that it be treated as a truck if it is not equipped with any of the listed safety devices and the purchaser certifies in writing that the vehicle will not be equipped for use as a tractor.[129]

In *Freightliner of Grand Rapids, Inc. v. U.S.,* the district court held that certain vehicles primarily designed to tow large RV trailers but which had some cargo carrying capacity on their chassis are properly characterized as tractors.[130] The court also held that incomplete chassis cabs that do not include any of the listed safety devices are to be treated as tractors unless the purchaser certifies in writing that it will not equip the vehicles for use as tractors. Under the holding of this case, these types of vehicles are subject to tax regardless of their gross vehicle weight.

### *Explanation of Provision*

The provision excludes from tax tractors that meet both of the following requirements. The tractor must have a gross vehicle

[125] Sec. 4051(a)(1).
[126] Sec. 4051(a)(2).
[127] Sec. 4051(a)(3).
[128] Temp. Treas. Reg. sec. 145.4051–1(e)(1)(i)
[129] Temp. Treas. Reg. sec. 145.4051–1(e)(1)(ii).
[130] 351 F.Supp.2d 718 (W.D. Mich. 2004).

weight of 19,500 pounds or less, and the gross combined weight (as determined by the Secretary) of the tractor if combined with a towed vehicle (such as trailer or semi-trailer) would not exceed 33,000 pounds. No inference is intended from this provision regarding the proper classification of vehicles as tractors or trucks.

### *Effective Date*

The provision is effective for sales after September 30, 2005.

### 3. Volumetric excise tax credit for alternative fuels (sec. 11113 of the Act and secs. 4041, 4101, 6426, and 6427 of the Code)

### *Present Law*

Under section 4081 of the Code, an excise tax is imposed upon (1) the removal of any taxable fuel from a refinery or terminal, (2) the entry of any taxable fuel into the United States, or (3) the sale of any taxable fuel to any person who is not registered with the IRS to receive untaxed fuel, unless there was a prior taxable removal or entry.[131] The tax does not apply to any removal or entry of taxable fuel transferred in bulk by pipeline or vessel to a terminal or refinery if the person removing or entering the taxable fuel, the operator of such pipeline or vessel, and the operator of such terminal or refinery are registered with the Secretary.[132] Section 4081 also imposes an excise tax on taxable fuel removed or sold by the blender of the fuels.[133] However, the blender is entitled to a credit on any tax previous paid if that person establishes the amount of such tax.[134] A "taxable fuel" is gasoline, diesel fuel (including any liquid, other than gasoline, which is suitable for use as a fuel in a diesel-powered highway vehicle or train), and kerosene.[135]

Diesel fuel and kerosene generally are taxed at 24.3 cents per gallon excise (aviation-grade kerosene at 21.8 cents per gallon). Gasoline is taxed at 18.3 cents per gallon and aviation gasoline is taxed at 19.3 cents per gallon.

The Code imposes a backup retail tax for diesel fuel and kerosene not taxed under section 4081, and for special motor fuels.[136] Under section 4041, tax is imposed on special motor fuels (any liquid other than gas oil, fuel oil or any product taxable under section 4081) when there is a taxable sale by any person to an owner, lessee or other operator of a motor vehicle or motorboat, for use as fuel in the motor vehicle or motorboat or used by any person as a fuel in a motor vehicle or motorboat unless there was a prior taxable sale.[137]

---

[131] Sec. 4081(a)(1).
[132] Sec. 4081(a)(1)(B).
[133] Sec. 4081(b)(1). Blended taxable fuel is a taxable fuel that is produced outside the bulk transfer/terminal system by mixing taxpayer fuel with respect to which tax has been imposed under section 4041(a)(1) or 4081(a) (other than taxable fuel for which a credit or payment has been allowed); and any other liquid on which tax has not been imposed under section 4081. Treas. Reg. sec. 48.4081–1(c)(i).
[134] Sec. 4081(b)(2).
[135] Sec. 4083(a).
[136] Sec. 4041.
[137] Sec. 4041(a)(2).

Most special motor fuels are subject to tax at 18.3 cents per gallon, however, certain special motor fuels and compressed natural gas are determined on an energy equivalent basis, as follows:

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

Liquid hydrogen is a special motor fuel for purposes of the tax on special motor fuels and is subject to a tax of 18.3 cents per gallon.[138] Compressed hydrogen gas used or sold as a fuel is not subject to tax.

Prior to the American Jobs Creation Act of 2004, gasohol and gasoline to be blended into gasohol was taxed at a reduced rate based on the amount of ethanol contained in the mixture (e.g., 10 percent, 7.7 percent or 5.5 percent alcohol in the mixture). The Act eliminated reduced rates of excise tax for most alcohol-blended fuels. In place of the reduced rates, the Act amended the Code to create two new excise tax credits: the alcohol fuel mixture credit and the biodiesel mixture credit.[139] The sum of these credits may be taken against the tax imposed on taxable fuels (by section 4081). A person may also file a claim for payment equal to the amount of these credits for biodiesel or alcohol used to produce an eligible mixture.[140] The credits and payments are paid out of the General Fund. If the alcohol is ethanol with a proof of 190 or greater, the credit or payment amount is 51 cents per gallon. For agri-biodiesel, the credit or payment amount is $1.00 per gallon; for biodiesel other than agri-biodiesel, the credit or payment amount is 50 cents per gallon. Under the Code's coordination rules, a claim may be taken only once with respect to any particular gallon of alcohol or biodiesel.

No excise tax credit is available for the blending or sale of special motor fuels.

### *Explanation of Provision*

Under the provision, liquefied petroleum gas and P Series fuels (as defined by the Secretary of Energy under 42 U.S.C. sec. 13211(2)) are taxed at 18.3 cents per gallon under section 4041. Compressed natural gas is taxed at 18.3 cents per energy equivalent of a gallon of gasoline. Liquefied natural gas, any liquid fuel derived from coal (other than ethanol or methanol) and liquid hydrocarbons derived from biomass are taxed at 24.3 cents per gallon under section 4041. The Act does not change the tax treatment of hydrogen, liquefied hydrogen remains subject to the tax imposed by section 4041.

---

[138] An additional 0.1 cent per gallon is imposed by section 4041(d) for the Leaking Underground Storage Tank Trust Fund.

[139] Sec. 6426. The American Jobs Creation Act of 2004 also created an income tax credit for biodiesel and biodiesel mixtures. Sec. 40A.

[140] Sec. 6427(e).

In addition, the provision creates two new excise tax credits, the alternative fuel credit, and the alternative fuel mixture credit. For this purpose, the term "alternative fuel" means liquefied petroleum gas, P Series fuels (as defined by the Secretary of Energy under 42 U.S.C. sec. 13211(2)), compressed or liquefied natural gas, liquefied hydrogen, liquid fuel derived from coal through the Fisher-Tropsch process, and liquid hydrocarbons derived from biomass. Such term does not include ethanol, methanol, or biodiesel.

The alternative fuel credit is allowed against section 4041 liability and the alternative fuel mixture credit is allowed against section 4081 liability. Neither credit is allowed unless the taxpayer is registered with the Secretary. The alternative fuel credit is 50 cents per gallon of alternative fuel or gasoline gallon equivalents[141] of nonliquid alternative fuel sold by the taxpayer for use as a motor fuel in a motor vehicle or motorboat, or so used by the taxpayer.

The alternative fuel mixture credit is 50 cents per gallon of alternative fuel used in producing an alternative fuel mixture for sale or use in a trade or business of the taxpayer. The mixture must be sold by the taxpayer producing such mixture to any person for use as a fuel or used by the taxpayer for use as a fuel.[142] The credits generally expire after September 30, 2009. The provision also allows persons to file a claim for payment equal to the amount of the alternative fuel credit and alternative fuel mixture credits. These payment provisions generally also expire after September 30, 2009. With respect to liquefied hydrogen, the credit and payment provisions expire after September 30, 2014. Both credits and payments are made out of the General Fund. Under coordination rules, a claim for payment or credit may only be taken once with respect to any particular gallon or gasoline-gallon equivalent of alternative fuel.

### *Effective Date*

The provision is effective for any sale or use for any period after September 30, 2006.

## B. Aquatic Excise Taxes

### 1. Eliminate Aquatic Resources Trust Fund and transform Sport Fish Restoration Account (sec. 11115 of the Act and secs. 9503 and 9504 of the Code)

### *Present Law*

A total tax rate of 18.4 cents per gallon is imposed on gasoline and special motor fuels used in motorboats, and on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power

[141] "Gasoline gallon equivalent" means, with respect to any nonliquid alternative fuel, the amount of such fuel having a Btu content of 124,800 (higher heating value).

[142] For example, the taxpayer produces fish oil in its trade or business. The taxpayer uses this fish oil to make a blend of 50 percent fish oil and 50 percent diesel fuel to run in a generator that is part of the taxpayer's trade or business. This use of the fish oil-diesel blend made by the taxpayer qualifies as use of an alternative fuel mixture for purposes of the requirement that the fuel be used in the blender's trade or business.

equipment.[143] Of this rate, 0.1 cent per gallon is dedicated to the Leaking Underground Storage Tank Trust Fund. Of the remaining 18.3 cents per gallon, tax collected in excess of 13.5 cents per gallon (i.e., 4.8 cents per gallon) is retained in the General Fund of the Treasury.[144] The balance is transferred to the Highway Trust Fund, and retransferred (except with respect to amounts transferred to the fund for land and water conservation, as described below) to the Aquatic Resources Trust Fund.[145] The taxes on gasoline and special motor fuels used in motorboats and the taxes on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment are collected under the same rules as apply to the Highway Trust Fund collections generally.

The Aquatic Resources Trust Fund is comprised of two accounts.[146] First, the Boat Safety Account is funded by a portion of the receipts from the excise tax imposed on motorboat gasoline and special motor fuels. Transfers to the Boat Safety Account are limited to amounts not exceeding $70 million per year. In addition, these transfers are subject to an overall annual limit equal to an amount that will not cause the Boat Safety Account to have an unobligated balance in excess of $70 million.[147]

Second, the Sport Fish Restoration Account receives the balance of the motorboat gasoline and special motor fuels receipts that are transferred to the Aquatic Resources Trust Fund.[148] The Sport Fish Restoration Account also is funded with receipts from an excise tax on sport fishing equipment sold by the manufacturer, producer or importer. The excise tax rate on sport fishing equipment is 10 percent of the sales price; the rate is reduced to 3 percent for electric outboard motors and fishing tackle boxes.[149] Examples of the items of sport fishing equipment subject to the 10-percent rate include fishing rods and poles, fishing reels, fly fishing lines and certain other fishing lines, fishing spears, spear guns, spear tips, items of terminal tackle, containers designed to hold fish, fishing vests, landing nets, and portable bait containers.[150] In addition, import duties on certain fishing tackle, yachts and pleasure craft are transferred into the Sport Fish Restoration Account.

The amounts of taxes on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment that are transferred to the Highway Trust Fund and retransferred to the Aquatic

---

[143] Sec. 4081(a)(2).

[144] The retention in the General Fund of the 4.8 cents a gallon of motorboat fuel taxes and taxes on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment expires after September 30, 2005.

[145] Sec. 9503(c)(4). Between October 1, 2001 and September 30, 2003, the amount transferred to the Highway Trust Fund was 13 cents per gallon. Prior to October 1, 2001, the amount transferred was 11.5 cents per gallon. Sec. 9503(b)(4)(D). The transfers from the Highway Trust Fund to the Aquatic Resources Trust Fund of amounts of taxes received on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment expires after September 30, 2005. Sec. 9503(c)(5).

[146] Sec. 9504(a).

[147] Sec. 9503(c)(4)(A). Funding of the Boat Safety Account is scheduled to expire after September 30, 2005.

[148] After funding of the Boat Safety Account, remaining motorboat fuel taxes, not exceeding $1,000,000 during any fiscal year, are transferred from the Highway Trust Fund into the land and water conservation fund provided in Title I of the Land and Water Conservation Fund Act of 1965. Sec. 9503(c)(4)(B). After the transfer to the land and water conservation fund, motorboat fuel taxes remaining in the Highway Trust Fund are transferred to the Sport Fish Restoration Account. Sec. 9503(c)(4)(C).

[149] Sec. 4161(a)(2) and 4161(a)(c)(3).

[150] Items of "sport fishing equipment" are enumerated in section 4162(a).

Resources Trust Fund are directed to a separate sub-account of the Sport Fish Restoration Account, the Coastal Wetlands Sub-Account.

Expenditures from the Boat Safety Account are subject to annual appropriations. Amounts transferred, paid, or credited to the Sport Fish Restoration Account (including the Coastal Wetlands Sub-Account) are authorized to be appropriated for the uses authorized in the expenditure provisions.[151]

### *Reasons for Change*

The Congress believes that the current Boat Safety Account is fully funded and that expenditures for boating safety relating to newly collected funds would be facilitated by treating these collections in the same manner as those currently required for the Sport Fish Restoration Account. The Congress further believes that combining the Boat Safety Account and Sport Fish Restoration Account will facilitate such uniform treatment in the future and better coordinate expenditures for sport fishing and boating safety.

### *Explanation of Provision*

The provision eliminates the Aquatic Resources Trust Fund and future transfers to the Boat Safety Account and transforms the Sport Fish Restoration Account into the Sport Fish Restoration and Boating Trust Fund. After funding of the land and water conservation fund as under present law, the balance of the taxes on motorboat fuels is transferred from the Highway Trust Fund into the Sport Fish Restoration and Boating Trust Fund. In addition, the transfers from the Highway Trust Fund to the Sport Fish Restoration and Boating Trust Fund of amounts of taxes on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment are extended through September 30, 2011.

Existing amounts in the Boat Safety Account, plus interest accrued on interest-bearing obligations of such account, are made available as provided under expenditure provisions.[152] The expenditure provisions also authorize the appropriation of amounts in the Sport Fish Restoration and Boating Trust Fund, including for boating safety, for the uses authorized in the expenditure provisions.

### *Effective Date*

The provision is effective October 1, 2005.

## 2. Repeal of harbor maintenance tax on exports (sec. 11116 of the Act and sec. 4461 of the Code)

### *Present Law*

The Code contains provisions imposing a 0.125-percent excise tax on the value of most commercial cargo loaded or unloaded at U.S.

---

[151] Act of August 9, 1950, 64 Stat. 430 (codified at 16 U.S.C. sec. 777 et seq.) ("An Act to provide that the United States shall aid the States in fish restoration and management projects, and for other purposes," commonly referred to as the Dingell-Johnson Sport Fish Restoration Act.).

[152] The expenditure provisions are codified at 16 U.S.C. sec. 777 et seq., as may be amended by the Sportfishing and Recreational Boating Safety Act of 2005.

ports (other than ports included in the Inland Waterway Trust Fund system). The tax also applies to amounts paid for passenger transportation using these U.S. ports. Exemptions are provided for (1) cargo donated for overseas use, (2) cargo shipped between the U.S. mainland and Alaska (except for crude oil), Hawaii, and/or U.S. possessions and (3) cargo shipped between Alaska, Hawaii, and/or U.S. possessions. Receipts from this tax are deposited in the Harbor Maintenance Trust Fund.

The U.S. Supreme Court has held that the harbor maintenance excise tax is unconstitutional as applied to exported cargo because it violates the "Export Clause" of the U.S. Constitution.[153] The tax remains in effect for imported cargo. Imposition of the tax on passenger transportation with respect to passengers on cruises that originate, stop, or terminate, at U.S. ports has been upheld.

### *Reasons for Change*

The Congress believes the Internal Revenue Code should conform to the law of the land as interpreted by the Supreme Court and, thus, believes the harbor maintenance excise tax as applied to exported cargo should be repealed as deadwood.

### *Explanation of Provision*

The provision conforms the Code to the Supreme Court decision and exempts exported commercial cargo from the harbor maintenance tax.

### *Effective Date*

The provision is effective before, on, and after the date of enactment (August 10, 2005).

## 3. Cap on excise tax on certain fishing equipment (sec. 11117 of the Act and sec. 4161 of the Code)

### *Present Law*

In general, the Code imposes a 10-percent tax on the sale by the manufacturer, producer, or importer of specified sport fishing equipment.[154] A three-percent rate, however, applies to the sale of electric outboard motors and fishing tackle boxes.[155] Sport fishing equipment subject to the 10-percent tax includes fishing rods and poles, fishing reels, fly fishing lines, and other fishing lines not over 130 pounds test, fishing spears, spear guns, and spear tips, and tackle items including leaders, artificial lures, artificial baits, artificial flies, fishing hooks, bobbers, sinkers, snaps, drayles, and swivels. In addition the following fishing supplies and accessories are subject to the 10-percent tax: fish stringers; creels; bags, baskets, and other containers designed to hold fish; portable bait containers; fishing vests; landing nets; gaff hooks; fishing hook disgorgers; dressing for fishing lines and artificial flies; fishing tip-

[153] *United States Shoe Corp.* v. *United States,* 523 U.S. 360, 118 S. Ct. 1290, 140 L. Ed. 2d 453 (1998).
[154] Sec. 4161(a)(1).
[155] Sec. 4161(a)(2) and 4161(a)(3).

ups and tilts; fishing rod belts, fishing rodholders; fishing harnesses; fish fighting chairs; and fishing outriggers and downriggers.

Revenues from the excise tax on sport fishing equipment are deposited in the Sport Fish Restoration Account of the Aquatic Resources Trust Fund. Monies in the fund are spent, subject to an existing permanent appropriation, to support Federal-State sport fish enhancement and safety programs.

### *Reasons for Change*

The Congress understands that as a tax on the manufacturer, the 10-percent *ad valorem* tax rate generally is imposed at the time a rod is sold to a wholesaler or retailer and thus the tax as a percentage of the ultimate retail price paid by the consumer is less than 10 percent. However, the Congress understands that most rods priced in excess of $100 are custom rods produced by businesses that are both the "manufacturer" and the retailer. In this circumstance the 10-percent tax rate would apply to the retail price. The Congress therefore believes that present-law tax does not provide for neutral taxation of different segments of the fishing rod market. The Congress concludes that the tax on rods and poles the manufacturer's price of which exceeds $100 should be limited to $10.00.

### *Explanation of Provision*

The provision provides that the tax applicable to a fishing rod or fishing pole is the lesser of 10 percent or $10.00.

### *Effective Date*

The provision is effective for articles sold by the manufacturer, producer, or importer after September 30, 2005.

## C. Aerial Excise Taxes

### 1. Clarification of excise tax exemptions for agricultural aerial applicators and exemption for fixed-wing aircraft engaged in forestry operations (sec. 11121 of the Act and secs. 4261 and 6420 of the Code)

### *Present Law*

Excise taxes are imposed on aviation gasoline (19.4 cents per gallon) and jet fuel (21.9 cents per gallon).[156] All but 0.1 cent per gallon of the revenues from these taxes are dedicated to the Airport and Airway Trust Fund. The remaining 0.1 cent per gallon rate is imposed for the Leaking Underground Storage Tank Trust Fund.

Fuel used on a farm for farming purposes is a nontaxable use. Aerial applicators (crop dusters) are allowed to claim a refund instead of farm owners and operators in the case of aviation gasoline if the owners or operators give written consent to the aerial applicators.[157] This provision applies only to fuel consumed in the air-

[156] Sec. 4081.
[157] Sec. 6420(c)(4)).

plane while operating over the farm, i.e., fuel consumed traveling to and from the farm is not exempt.

Air passenger transportation is subject to an excise tax equal to 7.5 percent of the amount paid plus $3.20 (for 2005) per domestic flight segment.[158] The tax on transportation by air does not apply to air transportation by helicopter if the helicopter is used for (1) the exploration, or the development or removal of oil, gas, or hard minerals exploration, or (2) certain timber operations (planting, cultivating, cutting, transporting, or caring for trees, including logging operations).[159] The exemption applies only when the helicopters are not using the Federally funded airport and airway services. Helicopters and fixed-wing aircraft providing emergency medical services also are exempt from the air passenger tax regardless of the type of airport and airway services used.[160]

### *Reasons for Change*

The Congress believes significant simplification and reduction of administrative burden will be achieved by eliminating the requirements that aerial applicators obtain written consent from the farm owner for exempt fuel use and by allowing exempt fuel use to extend to fuel consumed when flying between the farms where chemicals are applied and the airport where the airplane takes off and lands. In addition, the Congress notes that the purpose of the aviation excise taxes is to generate revenue for the Airport Improvement program, which builds new and retrofits and expands existing public airports. The Congress believes it is appropriate to extend the current exemption for helicopters engaged in timber operations to fixed wing aircraft when such aircraft are not using the Federally funded airport and airway services.

### *Explanation of Provision*

With regard to the exemption for aerial applicators, written consent from the farm owner or operator is no longer needed for the aerial applicator to claim exemption for aviation gasoline. The exemption also is expanded to include fuels consumed when flying between the farms where chemicals are applied and the airport where the airplane takes off and lands. The present exemption for helicopters engaged in timber operations is expanded to include fixed-wing aircraft if such aircraft are not using the Federally funded airport and airway services.

### *Effective Date*

The provision is effective for fuel use or air transportation after September 30, 2005.

---

[158] Sec. 4261(a) and 4261(b).
[159] Sec. 4261(f).
[160] Sec. 4261(g).

### 2. Modify the definition of rural airport (sec. 11122 of the Act and sec. 4261 of the Code)

#### *Present Law*

Air passenger transportation is subject to an excise tax equal to 7.5 percent of the amount paid plus $3.20 (in 2005) per domestic flight segment.[161] The $3.20 tax on flight segments does not apply to a domestic segment beginning or ending at a rural airport.

With respect to any calendar year, a rural airport is an airport that had fewer than 100,000 passengers departing by air during the second preceding calendar year for such airport and such airport either (1) is not located within 75 miles of a larger airport (one that had at least 100,000 passengers departing in the second preceding calendar year), or (2) was receiving essential air service subsidy payments as of August 5, 1997.

#### *Reasons for Change*

The Congress notes that the present-law definition of "rural airports" generally encompasses those airports that do not offer potential customers a viable alternative to a larger airport from which a ticket would subject the purchaser to the flight segment tax in addition to the ad valorem tax. The Congress observes that airports located on islands with no direct access by road from the mainland also would not offer potential customers a viable alternative to a larger airport, even if the island airport is within 75 miles of the larger airport.

#### *Explanation of Provision*

The provision expands the definition of qualified rural airport to include an airport that (1) is not connected by paved roads to another airport and (2) had fewer than 100,000 commercial passengers departing by air on flight segments of at least 100 miles during the second preceding calendar year.

#### *Effective Date*

The provision is effective on October 1, 2005.

### 3. Exempt from ticket taxes transportation provided by seaplanes (sec. 11123 of the Act and secs. 4261 and 4083 of the Code)

#### *Present Law*

Air passenger transportation is subject to an excise tax equal to 7.5 percent of the amount paid plus $3.20 (in 2005) per domestic flight segment ("air passenger tax").[162] A 6.25-percent tax is imposed on amounts paid for transportation of property by air ("air cargo tax").[163] The air cargo tax applies only to amounts paid to persons engaged in the business of transporting property by air for hire. The air passenger tax and air cargo tax do not apply to

[161] Sec. 4261(a) and 4261(b).
[162] Sec. 4261(a) and 4261(b).
[163] Sec. 4271.

amounts paid for the transportation if furnished on an aircraft having a maximum certificated takeoff weight of 6,000 pounds or less unless the aircraft is operated on an established line.[164]

### *Reasons for Change*

The Congress observes that seaplanes do not make as full utilization of Federal Aviation Administration services as do planes that offer passenger service out of traditional airports. The Congress, therefore, believes it is appropriate to exempt such service from the air transportation excise taxes and instead impose only the fuels excise taxes.

### *Explanation of Provision*

The provision provides that the air passenger tax and the air cargo tax do not apply to transportation by a seaplane with respect to any segment consisting of a takeoff from, and a landing on, water, but only if the places at which such takeoff and landing occur have not received and are not receiving financial assistance from the Airport and Airway Trust Fund. For purposes of the fuel taxes, transportation by seaplane is treated as noncommercial aviation.

### *Effective Date*

The provision is effective for transportation beginning after September 30, 2005.

## 4. Exempt certain sightseeing flights from taxes on air transportation (sec. 11124 of the Act and sec. 4281 of the Code)

### *Present Law*

Under present law, taxable aviation transportation is subject to a 7.5-percent excise tax on the price of an airline ticket plus $3.20 (in 2005) per domestic flight segment. An exception to these taxes is provided for transportation by an aircraft having a maximum certificated takeoff weight of 6,000 pounds or less except when the aircraft is operated on an established line. Under the Treasury regulations to be "operated on an established line" means to be operated with "some degree of regularity between definite points. The term implies that the air carrier maintains control over the direction, routes, time, number of passengers carried, etc."[165] Treasury regulations provide that transportation need not be between two definite points to be taxable: a payment for continuous transportation beginning and ending at the same point is subject to the tax.[166] The IRS position is that the words "between definite points" do not require two separate points for purposes of determining

[164] Sec. 4281.
[165] Treas. Reg. sec. 49.4263–5(c).
[166] Treas. Reg. sec. 49.4261–1(c).

whether an aircraft is operated on an established line. At least one court has agreed.[167]

### *Reasons for Change*

The Congress believes it is appropriate to exempt certain sightseeing flights from the taxes on air transportation. Examples of sightseeing flights include flights of short duration that overlook a glacier, volcano, the Grand Canyon, or other similar attraction and for which the air tour begins and ends at the same point. By short duration, the Congress intends that the tour occur within a calendar day, irrespective of intermittent stops to view the attraction. In addition, all passengers from the initial point of departure must return with the aircraft at the conclusion of the tour. The Congress believes that such flights are primarily for entertainment rather than for transportation from one place to another and so should be treated as noncommercial aviation.

### *Explanation of Provision*

For purposes of the exemption for small aircraft operated on nonestablished lines, an aircraft operated on a flight, the sole purpose of which is sightseeing, will not be considered as operated on an established line.

### *Effective Date*

The provision is effective with respect to transportation beginning after September 30, 2005, but does not apply to any amount paid before such date for such transportation.

## D. Taxes Relating to Alcohol

### 1. Repeal special occupational taxes on producers and marketers of alcoholic beverages (sec. 11125 of the Act and secs. 5081, 5091, 5111, 5112, 5113, 5117, 5121, 5122, 5123, 5125, 5131, 5132, 5141, 5147, 5148, and 5276 of the Code)

### *Present Law*

Under the law in effect prior to July 1, 2005, special occupational taxes are imposed on producers and others engaged in the marketing of distilled spirits, wine, and beer. These excise taxes are imposed as part of a broader Federal tax and regulatory structure governing the production and marketing of alcoholic beverages. The special occupational taxes are payable annually, on July 1 of each year. The tax rates in effect prior to July 1, 2005 are as follows:

| | |
|---|---|
| Producers:[168] | |
| Distilled spirits and wines (sec. 5081)[169] | $1,000 per year, per premise |

[167] *Lake Mead Air Inc.* v. *United States,* 991 F. Supp. 1209 (D. Nev. 1997) (the court determined that aircraft flights providing scenic tours of the Grand Canyon were operated on an established line).

| | |
|---|---|
| Brewers (sec. 5091) | $1,000 per year, per premise |
| Wholesale dealers (sec. 5111): | |
| Liquors, wines, or beer | $500 per year |
| Retail dealers (sec. 5121): | |
| Liquors, wines, or beer | $250 per year |
| Nonbeverage use of distilled spirits (sec. 5131) | $500 per year |
| Industrial use of distilled spirits (sec. 5276) | $250 per year |

Section 246(a) of the American Jobs Creation Act of 2004 suspends the special occupational tax for the period beginning July 1, 2005 and ending June 30, 2008.[170]

Every person engaged in a trade or business on which a special occupational tax is imposed is required to register with the Secretary.[171] In addition, every dealer in liquors, wine or beer is required to keep records of their transactions.[172] A dealer is any person who sells, or offers for sale, distilled spirits, wine, or beer.[173] A delegate of the Secretary of the Treasury is authorized to inspect the records of any dealer during business hours.[174] There are penalties for failing to comply with the recordkeeping requirements.[175] There are also registration and regulation requirements for the nonbeverage use of distilled spirits, and permit and recordkeeping requirements for the industrial use of distilled spirits.[176]

The Code limits the persons from whom dealers may purchase their liquor stock intended for resale. A dealer may only purchase from:

1. a wholesale dealer in liquors who has paid the special occupational tax as such dealer to cover the place where such purchase is made; or
2. a wholesale dealer in liquors who is exempt, at the place where such purchase is made, from payment of such tax under any provision of chapter 51 of the Code; or
3. a person who is not required to pay special occupational tax as a wholesale dealer in liquors.[177]

Violation of this restriction in punishable by $1,000 fine, imprisonment of one year, or both.[178] A violation also subjects the alcohol to seizure and forfeiture.[179]

---

[168] A reduced rate of tax in the amount of $500.00 is imposed on small proprietors (as defined in the Code) (secs. 5081(b) and 5091(b)).

[169] Proprietors of plants producing distilled spirits exclusively for fuel use, with annual production not exceeding 10,000 proof gallons, are exempt. Secs. 5081(c) and 5181(c)(4).

[170] See sec. 5148.

[171] Secs. 5141 and 7011. The registration is of such person's name or style, place of residence, trade or business, and the place where such trade or business is to be carried on.

[172] Secs. 5114 and 5124.

[173] Sec. 5112(a). Such definition includes producers and, in general, proprietors of warehouses.

[174] Sec. 5146.

[175] Sec. 5603.

[176] Secs. 5132 and 5275.

[177] Sec. 5117. For example, purchases from a proprietor of a distilled spirits plant at his principal business office would be covered under item (2) since such a proprietor is not subject to the special occupational tax on account of sales at his principal business office (sec. 5113(a)). Purchases from a State-operated liquor store would be covered under item (3) (sec. 5113(b)).

[178] Sec. 5687.

[179] Sec. 7302.

### *Reasons for Change*

The special occupational tax is not a tax on alcoholic products but rather operates as a license fee on businesses. The Congress believes that this tax places an unfair burden on business owners. However, the Congress recognizes that the registration and recordkeeping requirements applicable to wholesalers and retailers engaged in such businesses are necessary enforcement tools to ensure the protection of the revenue arising from the excise taxes on these products. Thus, the Congress believes it appropriate to repeal the tax, while retaining present-law recordkeeping requirements.

### *Explanation of Provision*

The provision repeals the special occupational taxes on producers and marketers of alcoholic beverages and on the nonbeverage or industrial use of distilled spirits. The registration, recordkeeping and inspection rules applicable to wholesale and retail dealers are retained.[180] For purposes of the recordkeeping requirements for wholesale and retail liquor dealers, the Act provides a rebuttable presumption that a person who sells, or offers for sale, distilled spirits, wine, or beer, in quantities of 20 wine gallons or more to the same person at the same time is engaged in the business of a wholesale dealer in liquors or a wholesale dealer in beer. In addition, the Act retains the present-law rules that make it unlawful for any liquor dealer to purchase distilled spirits for resale from any person other than a wholesale liquor dealer subject to the recordkeeping requirements, or a proprietor of a distilled spirits plant subject to recordkeeping requirements.[181] Existing general criminal penalties relating to records and reports apply to wholesalers and retailers who fail to comply with these requirements.

### *Effective Date*

The provision is effective on July 1, 2008. The provision does not affect liability for taxes imposed with respect to periods before July 1, 2008.

## 2. Provide an income tax credit for cost of carrying tax-paid distilled spirits in wholesale inventories and in control State bailment warehouses (sec. 11126 of the Act and new sec. 5011 of the Code)

### *Present Law*

As is true of most major Federal excise taxes, the excise tax on distilled spirits is imposed at a point in the chain of distribution before the product reaches the retail (consumer) level. The excise tax on distilled spirits produced in the United States is imposed when the distilled spirits are removed from the distilled spirits plant where they are produced. Distilled spirits that are bottled be-

[180] The provision also retains the present-law registration and regulation requirements for the nonbeverage use of distilled spirits, and the permit and recordkeeping requirements for the industrial use of distilled spirits.

[181] Proprietors of distilled spirits plants remain subject to present law recordkeeping requirements under section 5207. Under present law, a limited retail dealer in liquors (such as a charitable organization selling liquor at a picnic) may lawfully purchase distilled spirits for resale from a retail dealer in distilled spirits. The provision retains this rule.

fore importation into the United States are taxed on removal from the first U.S. customs bonded warehouse to which they are landed (including a warehouse located in a foreign trade zone). Distilled spirits imported in bulk containers for bottling in the United States may be transferred to a domestic distilled spirits plant without payment of tax; subsequently, these distilled spirits are taxed in the same way as domestically produced distilled spirits.

No tax credits are allowed under present law for business costs associated with having tax-paid products in inventory. Rather, excise tax that is included in the purchase price of a product is treated the same as the other components of the product cost, i.e., deductible as a cost of goods sold.

### *Reasons for Change*

Under current law, wholesale importers of distilled spirits are not required to pay the Federal excise tax on imported spirits until after the product is removed from a bonded warehouse for sale to a retailer. In contrast, the tax on domestically produced spirits is included as part of the purchase price and passed on from the supplier to wholesaler. It is the Congress's understanding that in some instances, wholesalers can carry this tax-paid inventory for an average of 60 days before selling it to a retailer. The Congress believes it is appropriate to provide an income tax credit to approximate the interest charge—more commonly referred to as float—that results from carrying tax-paid distilled spirits in inventory.

### *Explanation of Provision*

The provision creates a new income tax credit for eligible wholesalers, distillers, and importers, of distilled spirits. The credit is in addition to present-law rules allowing tax included in inventory costs to be deducted as a cost of goods sold, and is treated as part of the general business credits.

The credit is calculated by multiplying the number of cases of bottled distilled spirits by the average tax-financing cost per case for the most recent calendar year ending before the beginning of such taxable year. A case is 12 80-proof 750-milliliter bottles. The average tax-financing cost per case is the amount of interest that would accrue at corporate overpayment rates during an assumed 60-day holding period on an assumed tax rate of $25.68 per case of 12 80-proof 750-milliliter bottles.

The wholesaler credit only applies to domestically bottled distilled spirits[182] purchased directly from the bottler of such spirits. An eligible wholesaler is any person that holds a permit under the Federal Alcohol Administration Act as a wholesaler of distilled spirits that is not a State, or agency or political subdivision thereof.

For distillers and importers that are not eligible wholesalers, the credit is limited to bottled inventory in a warehouse owned and operated by, or on behalf of, a State or political subdivision thereof, when title to such inventory has not passed unconditionally. The credit for distillers and importers applies to distilled spirits bottled both domestically and abroad.

[182] Distilled spirits that are imported in bulk and then bottled domestically qualify as domestically bottled distilled spirits.

### *Effective Date*

The provision is effective for taxable years beginning after September 30, 2005.

## 3. Quarterly excise tax filing for small alcohol excise taxpayers (sec. 11127 of the Act and sec. 5061 of the Code)

### *Present Law*

In general, excise taxes on distilled spirits, wines, and beers are collected on the basis of returns filed in accordance with rules prescribed by the Secretary of the Treasury.[183] In the case of distilled spirits, beer, and wine withdrawn under bond for deferred payment of tax ("deferred payment bond"), domestic producers are generally required to pay alcohol excise taxes within 14 days after the last day of the semi-monthly period during which the article is withdrawn.[184] In the case of distilled spirits, wines, and beer which are imported into the United States (other than in bulk containers), the importer is generally required to pay alcohol excise taxes within 14 days after the last day of the semi-monthly period during which the article is entered into the customs territory of the United States.[185] In the case of imported articles entered for warehousing, the taxes are generally due within 14 days after the last day of the semi-monthly period during which the article is removed from the first such warehouse.[186] Treasury regulations also permit certain very small wine producers to file and pay on an annual basis.[187]

Special rules apply to accelerate payments made with respect to taxes allocable to the second half of the month of September.[188]

### *Reasons for Change*

The Congress believes that the payment of alcohol excise taxes and filing of the related tax returns on a semi-monthly basis are a heavy burden for small businesses engaged in the production and importation of distilled spirits, wines and beers. The Congress wishes to lighten the paperwork load on these taxpayers by permitting filing and payment on a quarterly basis.

### *Explanation of Provision*

Under the provision, domestic producers and importers of distilled spirits, wine, and beer with excise tax liability of $50,000 or less attributable to such articles in the preceding calendar year may file returns and pay taxes within 14 days after the end of the calendar quarter instead of semi-monthly. In order to qualify, the taxpayer's liability for such taxes during the immediately preceding year must have been $50,000 or less, and, as of the beginning of the current calendar year, the taxpayer must reasonably expect to

---

[183] Sec. 5061(a).
[184] Sec. 5061(d)(1).
[185] Sec. 5061(d)(2)(A).
[186] Sec. 5061(d)(2)(B).
[187] Annual filing and payment is permitted to a wine producer who has not given a deferred payment bond, and who either paid wine excise taxes in an amount less than $1,000 during the previous calendar year or is a proprietor of a new bonded wine premise and expects to pay less than $1,000 in wine excise taxes before the end of the calendar year. 27 CFR sec. 24.273(a).
[188] Sec. 5061(d)(4).

pay less than $50,000 in such taxes for that year. The provision does not apply to a taxpayer for any portion of the calendar year following the first date on which the aggregate amount of tax due for that year exceeds the $50,000 threshold.

The special rules accelerating payments for taxes allocable to the second half of September do not apply to quarterly filers under the provision.

The quarterly filing and payment applies only to withdrawals, removals, and entries (and articles brought into the United States from Puerto Rico) under deferred payment bonds. Transactions that are not made under deferred payment bonds do not qualify for quarterly filing and payment, but do count toward determining whether the $50,000 threshold has been reached. However, very small wine producers who have not given deferred payment bonds may still file and pay on an annual basis as under present law.

### *Effective Date*

The provision is effective for quarterly periods beginning on and after January 1, 2006.

## E. Sport Excise Taxes

### 1. Custom gunsmiths (sec. 11131 of the Act and sec. 4182 of the Code)

### *Present Law*

The Code imposes an excise tax upon the sale by the manufacturer, producer or importer of certain firearms and ammunition.[189] Pistols and revolvers are taxable at 10 percent. Firearms (other than pistols and revolvers), shells, and cartridges are taxable at 11 percent. The excise tax for firearms imposed on manufacturers, producers, and importers does not apply to machine guns and short barreled firearms. Sales to the Defense Department of firearms, pistols, revolvers, shells and cartridges also are exempt from the tax.

### *Reasons for Change*

Many custom gunsmiths do not actually make new guns, rather they remodel or refurbish existing firearms. The provision establishes an exemption from the excise tax for manufacturers of fewer than 50 firearms per year. The Congress believes two objectives are accomplished under the provisions. First, this provision eliminates the imposition of the excise tax on custom gunmakers, and second, it eliminates an administrative burden placed on small businesses.

### *Explanation of Provision*

The provision exempts from the firearms excise tax firearms, pistols, and revolvers manufactured, produced, or imported by a person who manufactures, produces, and imports less than 50 of such articles during the calendar year. Controlled groups are treated as a single person for determining the 50-article limit.

[189] Sec. 4181.

### *Effective Date*

The provision is effective for articles sold by the manufacturer, producer, or importer after September 30, 2005. No inference is intended from the prospective effective date of this provision as to the proper treatment of pre-effective date sales.

## III. MISCELLANEOUS PROVISIONS

### A. Motor Fuel Tax Enforcement Advisory Commission (sec. 11141 of the Act)

#### *Present Law*

Present law does not require that there be an advisory commission on motor tax fuel enforcement.

#### *Reasons for Change*

The Congress believes that motor fuel tax administration can be improved through the cooperation and shared experiences of the various stakeholders in motor fuel tax enforcement. Therefore, the Congress believes it appropriate to create an advisory commission for motor fuel tax enforcement consisting of both Government and private sector members.

#### *Explanation of Provision*

The provision establishes a "Motor Fuel Tax Enforcement Advisory Commission" (the "Commission"). The purpose of the Commission is to: (1) review motor fuel revenue collections, historical and current; (2) review the progress of investigations with respect to motor fuel taxes; (3) develop and review legislative proposals with respect to motor fuel taxes; (4) monitor the progress of administrative regulation projects relating to motor fuel taxes; (5) review the results Federal and State agency cooperative efforts regarding motor fuel taxes; and (6) review the results of Federal interagency cooperative efforts regarding motor fuel taxes. The Commission also is to evaluate and make recommendations regarding: (1) the effectiveness of existing Federal enforcement programs regarding motor fuel taxes; (2) enforcement personnel allocation; and (3) proposals for regulatory projects, legislation, and funding.

The Commission is to be composed of the following:

- At least one representative from each of the following Federal entities: the Department of Homeland Security, the Department of Transportation—Office of Inspector General, the Federal Highway Administration, the Department of Defense, and the Department of Justice;
- At least one representative from the Federation of State Tax Administrators;
- At least one representative from any State Department of Transportation;
- Two representatives from the highway construction industry;
- Six representatives from industries relating to fuel distribution: refiners (two representatives), distributors (one rep-

resentative), pipelines (one representative), terminal operators (two representatives);

- One representative from the retail fuel industry; and
- Two representatives each from the staff of the Senate Committee on Finance and the House Committee on Ways and Means.

Members of the Commission are to be appointed by the Chairmen and Ranking Members of the Senate Committee on Finance and the House Committee on Ways and Means. Representatives from the Department of Treasury and the IRS shall be available to consult with the Commission upon request.

The Commission may secure directly from any department or agency of the United States, information (other than information required by law to be kept confidential by such department or agency) necessary for the Commission to carry out its duties. Upon request of the Commission, the head of that department or agency shall furnish such nonconfidential information to the Commission. The Commission also shall gather evidence through such means as it may deem appropriate, including through holding hearings and soliciting comments by means of Federal register notices.

The Commission is to terminate after September 30, 2009.

### *Effective Date*

The provision is effective on the date of enactment (August 10, 2005).

## B. National Surface Transportation Infrastructure Financing Commission (sec. 11142 of the Act)

### *Present Law*

Present law does not provide for any advisory commissions related Federal highway or mass transit funding.

### *Reasons for Change*

The Congress observes that, as the fuel economy of the nation's vehicular fleet improves, receipts flowing to the Highway Trust Fund will not grow commensurately with highway use. At the same time, the Congress recognizes that the nation's need for transportation infrastructure improvements is great. The Congress believes now is the time to engage in a review of the nation's long-term transportation infrastructure needs and a thoughtful reassessment of how to finance those needs.

### *Explanation of Provision*

The provision establishes a "National Surface Transportation Infrastructure Financing Commission" (the "Financing Commission"). The Financing Commission is to be composed of 15 members drawn from among individuals knowledgeable in the fields of public transportation finance or highway and transit programs, policy, and needs. Financing Commission members may include representatives of State and local governments or other public transportation agencies, representatives of the transportation construction indus-

try, providers of transportation, persons knowledgeable in finance, and users of highway and transit systems.

The Financing Commission will make an investigation and study of revenues flowing into the Highway Trust Fund under present law. The Financing Commission will consider whether the amount of such revenues is likely to increase, decline or remain unchanged absent changes in the law. The Financing Commission will consider alternative approaches to generating revenues for the Highway Trust Fund, and the level of revenues that such alternatives would yield. The Financing Commission will consider highway and transit needs and whether additional revenues into the Highway Trust Fund, or other Federal revenues dedicated to highway and transit infrastructure, would be required in order to meet such needs.

The Commission also must consider a program that would exempt all or a portion of gasoline or other motor fuels used in a State from the Federal excise tax on such gasoline or other motor fuels if such State elects not to receive all or a portion of Federal transportation funding, including: (1) whether such State should be required to increase State gasoline or other motor fuels taxes by the amount of the decrease in the Federal excise tax on such gasoline or other motor fuels; (2) whether any Federal transportation funding should not be reduced or eliminated for States participating in such program; (3) whether there are any compliance problems related to enforcement of Federal transportation-related excise taxes; and (4) study such other matters closely related to the subjects described in the preceding subparagraphs as it may deem appropriate.

The Financing Commission will develop a final report, with recommendations and the bases for those recommendations. The Financing Commission's recommendations will address: (1) what levels of revenue are required by the Highway Trust Fund in order for it to meet needs to maintain and improve the condition and performance of the nation's highway and transit systems; (2) what levels of revenue are required by the Highway Trust Fund in order to ensure that Federal levels of investment in highways and transit do not decline in real terms; and (3) the extent, if any, to which the Highway Trust Fund should be augmented by other mechanisms or funds as a Federal means of financing highway and transit infrastructure investments.

The Financing Commission will submit its report and recommendations within two years of the date of its first meeting to the Secretary of Transportation, the Secretary of the Treasury, the House Committee on Ways and Means, Senate Committee on Finance, the House Committee on Transportation and Infrastructure, the Senate Committee on Environment and Public Works, and Senate Committee on Banking, Housing, and Urban Affairs.

### *Effective Date*

The provision is effective on the date of enactment (August 10, 2005).

## C. Tax-Exempt Financing of Highway Projects and Rail-Truck Transfer Facilities (sec. 11143 of the Act and sec. 142 of the Code)

### *Present law*

#### *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 the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Interest on State or local bonds to finance activities of private persons ("private activity bonds") is taxable unless a specific exception is contained in the Code (or in a non-Code provision of a revenue Act). The term "private person" generally includes the Federal government and all other individuals and entities other than States or local governments.

*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.[190] The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); low-income residential rental property; 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; and, qualified green building/sustainable design projects.[191]

Issuance of most qualified private activity bonds is subject (in whole or in part) to annual State volume limitations.[192] Exceptions are provided for bonds for certain governmentally owned facilities (airports, ports, high-speed intercity rail, and solid waste disposal) and bonds which are subject to separate local, State, or national volume limits (public/private educational facilities, enterprise zone facility bonds, and qualified green building/sustainable design projects).

### *Explanation of Provision*

The provision establishes a new category of exempt facility bonds to finance qualified highway or surface freight transfer facilities ("qualified highway or surface freight transfer facility bonds"). A qualified highway facility or surface freight transfer facility is any surface transportation or international bridge or tunnel project (for which an international entity authorized under Federal or State

[190] Sec. 141(e).
[191] Sec. 142(a).
[192] Sec. 146.

law is responsible) which receives Federal assistance under title 23 of the United States Code or any facility for the transfer of freight from truck to rail or rail to truck which receives Federal assistance under title 23 or title 49 of the United States Code.

Under the provision, qualified highway or surface freight transfer facility bonds are not subject to the State volume limitations. Rather, the Secretary of Transportation is authorized to allocate a total of $15 billion of issuance authority to qualified highway or surface freight transfer facilities in such manner as the Secretary determines appropriate. Bonds are not treated as qualified highway or surface freight transfer facility bonds if the aggregate amount of bonds issued with respect to qualified facilities exceeds the amount of issuance authority allocated to such facilities by the Secretary of Transportation. The aggregate limitation on bonds that may be issued does not apply to the "current refunding" of qualified highway or surface freight transfer facility bonds. Bonds are treated as a current refunding for this purpose if: (1) the average maturity date of the refunding bond is not later than the average maturity date of the refunded bonds; (2) the amount of the refunding bond does not exceed the outstanding amount of the refunded bond, and (3) the refunded bond is redeemed not later than 90 days after the date of the issuance of the refunding bond.

Under the provision, the proceeds of qualified highway or surface freight transfer facility bonds must be spent on qualified projects within five years from the date of issuance of such bonds. Proceeds that remain unspent after five years must be used to redeem outstanding bonds. The provision authorizes the Secretary of the Treasury (or his delegate) to extend the five-year period if the issuer establishes that the need for the extension is appropriate and due to circumstances not within the control of the issuer.

Finally, the provision is not intended to expand the scope of any Federal requirement beyond its application under present law and does not broaden the application of any Federal requirement under present law in Title 49.

### *Effective Date*

The provision applies to bonds issued after the date of enactment (August 10, 2005).

## D. Treasury Study of Highway Fuels Used by Trucks for Non-Transportation Purposes (sec. 11144 of the Act)

### *Present Law*

Present law does not provide for a study of fuel use by trucks.

### *Explanation of Provision*

The provision directs the Secretary of the Treasury to study the use by trucks of highway motor fuel that is not used for the propulsion of the vehicle, both in the case of vehicles carrying equipment that is unrelated to the transportation function of the vehicle and in the case where non-transportation equipment is run by a separate motor. In addition, the Secretary is to estimate the amount of fuel consumed and pollutants emitted by trucks due to the long-

term idling of diesel engines, and report on the cost of reducing long-term idling through various technologies. The Secretary is to propose implementing exemptions from tax for fuel used in non-transportation uses, but only if the Secretary determines such exemptions are administratively feasible, for the following: (1) mobile machinery whose nonpropulsive fuel use exceeds 50 percent and (2) any highway vehicle that consumes fuel for both transportation- and non-transportation-related equipment, using a single motor. With respect to item (2), it is intended that the Secretary take into consideration such factors as whether the fuel use for non-transportation equipment by the vehicle operator is significant both relative to transportation-related fuel consumption of the vehicle and relative to the vehicle operator's business. There may be significant non-transportation use of taxed fuel even if such use is small relative to the vehicle's transportation use, if the vehicle is used extensively. Also with respect to item (2), it is intended that the Secretary take into account variations in fuel use among the different types of vehicles, such as concrete mixers, refuse collection vehicles, tow trucks, mobile drills, and other vehicles that the Secretary identifies.

Not later than January 1, 2007, the Secretary of the Treasury is to report the findings of the study to the Senate Committee on Finance and the House Committee on Ways and Means.

### *Effective Date*

The provision is effective on the date of enactment (August 10, 2005).

## E. Diesel Fuel Tax Evasion Report (sec. 11145 of the Act)

### *Present Law*

An excise tax is imposed upon (1) the removal of any taxable fuel from a refinery or terminal, (2) the entry of any taxable fuel into the United States, or (3) the sale of any taxable fuel to any person who is not registered with the IRS to receive untaxed fuel, unless there was a prior taxable removal or entry.[193] The tax does not apply to any removal or entry of taxable fuel transferred in bulk by pipeline or vessel to a terminal or refinery if the person removing or entering the taxable fuel, the operator of such pipeline or vessel, and the operator of such terminal or refinery are registered with the Secretary.[194]

Diesel fuel and kerosene that is to be used for a nontaxable purpose will not be taxed upon removal from the terminal if it is dyed to indicate its nontaxable purpose.[195] In addition to requirement that fuel be dyed, the Secretary has the authority to prescribe marking requirements for diesel fuel and kerosene destined for a nontaxable use.[196] The Secretary has not prescribed any marking requirements.

---

[193] Sec. 4081(a)(1).
[194] Sec. 4081(a)(1)(B).
[195] Sec. 4082(a)(1) and (2).
[196] Sec. 4082(a)(3).

### *Explanation of Provision*

The provision requires the Commissioner of the IRS to report on the availability of new technologies that can be employed to enhance the collections of the excise tax on diesel fuel and the plans of the IRS to employ such technologies. The report is to cover the availability of forensic or chemical molecular markers, in addition to other technologies, to enhance collections of the excise tax on diesel fuel and the plans of the Internal Revenue Service to employ such technologies. The report must also cover the design of three tests: (1) the design of a test to place forensic or chemical molecular markers in any excluded liquid as that term is defined in Treasury regulations; (2) the design of a test, in consultation with the Department of Defense, to place forensic or chemical molecular markers in all nonstrategic bulk fuel deliveries of diesel fuel to the military, and (3) the design of a test to place forensic or chemical molecular markers in all diesel fuel bound for export utilizing the Gulf of Mexico.

The report is to be submitted within 360 days from the date of enactment to the Senate Committees on Finance and Environment and Public Works, and the House Committees on Ways and Means and Transportation and Infrastructure.

### *Effective Date*

The provision is effective on the date of enactment (August 10, 2005).

## F. Tax Treatment of State Ownership of Railroad Real Estate Investment Trust (sec. 11146 of the Act and secs. 103, 115, 336, and 337 of the Code)

### *Present Law*

A real estate investment trust ("REIT") is an electing entity that is engaged primarily in passive real estate activities (as specifically defined) and that, among other requirements, must have at least 100 shareholders. If a qualified entity elects REIT status, it can pay little or no corporate level tax, since a REIT is allowed a deduction for amounts distributed to its shareholders and is required to distribute at least 90 percent of its income to shareholders annually.

If an entity does not qualify to be treated as a REIT, it would generally be treated as a regular corporation subject to corporate level tax on its income under subchapter C and section 11 of the Code. Such a corporation can elect to be taxed as a partnership or disregarded entity under Treasury regulations. However, if it made such an election, the corporation would be treated as if it had liquidated and distributed its assets to shareholders, generally resulting in corporate-level tax on the excess of the fair market value over the basis of corporate assets.[197] A corporation that itself be-

[197] Sec. 336. An exception to this gain recognition applies to certain liquidations into a corporation that owns 80 percent of the liquidating entity and that is not itself tax-exempt. Sec. 337.

comes a tax-exempt entity also must pay corporate tax on the excess of the fair market value over the basis of its assets.[198]

A State or local government is not subject to Federal income tax on income that accrues to the State or any political subdivision thereof and that is derived from any public utility or the exercise of any activity that is an essential governmental function.[199]

Interest on State and local bonds is excluded from gross income, with certain exceptions.[200] State and local bonds can be classified by the type of entity using the proceeds as either governmental or private activity bonds. In general, bonds are governmental bonds if the proceeds of the bonds are used to finance direct activities of governmental entities or if the bonds are repaid with revenues of governmental entities. Private activity bonds are bonds with respect to which a State or local government serves as a conduit providing financing to 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 purposes permitted by the Code. In addition, both governmental and private activity bonds must satisfy applicable rules provided for in the Code as a condition of tax exemption.[201]

### *Explanation of Provision*

Under the provision, the income of a qualified corporation that is derived from its railroad transportation and economic development activities, that constitute substantially all of its activities (as described below), is treated as accruing to the State for purposes of section 115, to the extent such activities are of a type which are an essential governmental function under section 115 of present law. For purposes of the provision, a qualified corporation is a corporation which is a REIT on the date of enactment (August 10, 2005) and which is a non-operating Class III railroad that becomes 100 percent owned by a State after December 31, 2003 and before December 31, 2006. Moreover, substantially all activities of the corporation must consist of the ownership, leasing, and operation by such corporation of facilities, equipment, and other property used by the corporation or other persons for railroad transportation and for economic development for the benefit of the State and its citizens.

Under the provision, no gain or loss shall be recognized from the deemed conversion of such a REIT to such a qualified corporation and no change in the basis of the property of the entity shall occur.

Also, any obligation issued by a qualified corporation described above is treated as an obligation of a State for purposes of applying the tax exempt bond provisions if 95 percent of the net proceeds of such obligation are to be used to provide for the acquisition, construction, or improvement of railroad transportation infrastructure (including railroad terminal facilities). In addition, such an obligation shall not be treated as a private activity bond solely by reason of the ownership or use of such railroad transportation infrastructure by the corporation. All other present-law provisions relating to

---

[198] Treas. Reg. sec. 1.337(d)–4(a)(2).
[199] Sec. 115.
[200] Sec. 103.
[201] Secs. 141–150.

tax exempt bonds continue to apply to and govern bonds issued by the corporation. For example, the use by a private business of railroad property financed with the proceeds of bonds issued by a qualified corporation may cause such bonds to be taxable private activity bonds.

### *Effective Date*

The provision applies on and after the date a State becomes the owner of all the outstanding stock of a qualified corporation through action of such corporation's board of directors, provided that the State becomes the owner of all the voting stock of the corporation on or before December 31, 2003 and becomes the owner of all the outstanding stock of the corporation on or before December 31, 2006.

## G. Leaking Underground Storage Tank Trust Fund (sec. 11147 of the Act)

### *Present Law*

#### *Leaking Underground Storage Tank Trust Fund*

The Code imposes an excise tax, generally at a rate of 0.1 cents per gallon, on gasoline, diesel, kerosene, and special motor fuels (other than liquefied petroleum gas and liquefied natural gas).[202] The taxes are deposited in the Leaking Underground Storage Tank ("LUST") Trust Fund.

Amounts in the LUST Trust Fund are available, subject to appropriation, only for purposes of making expenditures to carry out section 9003(h) of the Solid Waste Disposal Act as in effect on the date of enactment of the Superfund Amendments and Reauthorization Act of 1986.[203]

#### *Highway Trust Fund*

The Highway Trust Fund provisions of the Code contain a special enforcement provision to prevent expenditure of Highway Trust Fund monies for purposes not authorized in section 9503 or a revenue Act.[204] If such unapproved expenditures occur, no further excise tax receipts will be transferred to the Highway Trust Fund. Rather, the taxes will continue to be imposed with receipts being retained in the General Fund. This enforcement provision provides specifically that it applies not only to unauthorized expenditures under the current Code provisions, but also to expenditures pursuant to future legislation that does not amend section 9503's expenditure authorization provisions or otherwise authorize the expenditure as part of a revenue Act.

---

[202] For qualified methanol and ethanol fuel the rate is 0.05 cents per gallon (sec. 4041(b)(2)(A)(ii). Qualified methanol or ethanol fuel is any liquid at least 85 percent of which consists of methanol, ethanol or other alcohol produced from coal (including peat) (sec. 4041(b)(2)(B)).

[203] Sec. 9508(c). The expenditures purposes of the LUST Trust Fund as set forth in the Code were subsequently amended by Division A, section 210 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

[204] Sec. 9503(b)(6).

### *Explanation of Provision*

The provision adds to the Code's LUST Trust Fund provisions a special enforcement provision similar to that applicable to the Highway Trust Fund to prevent expenditure of LUST Trust Fund monies for purposes not authorized by the Code or in a revenue Act.

### *Effective Date*

The provision is effective on the date of enactment (August 10, 2005).

## IV. PREVENTING FUEL FRAUD

### A. Treatment of Kerosene for Use in Aviation (sec. 11161 of the Act and secs. 4041, 4081, 4082, 6427, 9502, and 9503 of the Code)

#### *Present Law*

In general, aviation-grade kerosene is taxed at a rate of 21.8 cents per gallon upon removal of such fuel from a refinery or terminal (or entry into the United States) and on the sale of such fuel to any unregistered person unless there was a prior taxable removal or entry of such fuel.[205] Aviation-grade kerosene may be removed at a reduced rate, either 4.3 or zero cents per gallon, if the aviation fuel is removed directly into the fuel tank of an aircraft for use in commercial aviation[206] or for a use that is exempt from the tax imposed by section 4041(c) (other than by reason of a prior imposition of tax),[207] or is removed or entered as part of an exempt bulk transfer.[208] These taxes are credited to the Airport and Airway Trust Fund.[209] If taxed aviation-grade kerosene is used for a nontaxable use, a claim for credit or refund may be made.[210] Such claims are paid from the Airport and Airway Trust Fund to the general fund of the Treasury.[211] All other removals and entries of kerosene used for surface transportation are taxed at the diesel tax rate of 24.3 cents per gallon,[212] and these taxes are credited to the Highway Trust Fund.[213] If aviation-grade kerosene is taxed upon removal or entry but fraudulently diverted for surface transportation, the taxes remain in the Airport and Airway Trust Fund, and the Highway Trust Fund is not credited for the taxes on such fuel.

---

[205] Sec. 4081(a)(2)(A)(iv). An additional 0.1 cent is imposed on aviation-grade kerosene and credited to the Leaking Underground Storage Tank ("LUST") Trust Fund (sec. 4081(a)(2)(B)).

[206] Sec. 4081(a)(2)(C).

[207] Sec. 4082(e). Exempt uses include use in commercial aviation as supplies for vessels or aircraft, which includes use by certain foreign air carriers and for the international flights of domestic carriers, secs. 4082(e), 6427(l)(2), and 4221(d)(3).

[208] Sec. 4081(a)(1)(B).

[209] Sec. 9502(b)(1)(C).

[210] Sec. 6427(l)(1) and 6427(l)(4). Nontaxable uses include: (1) use other than as fuel in an aircraft (such as use in heating oil); (2) use on a farm for farming purposes; (3) use in a military aircraft owned by the United States or a foreign country; (4) use in a domestic air carrier engaged in foreign trade or trade between the United States and any of its possessions; (5) use in a foreign air carrier engaged in foreign trade or trade between the United States and any of its possessions (but only if the foreign carrier's country of registration provides similar privileges to United States carriers); (6) exclusive use of a State or local government; (7) sales for export, or shipment to a United States possession; (8) exclusive use by a nonprofit educational organization; (9) use by an aircraft museum exclusively for the procurement, care, or exhibition of aircraft of the type used for combat or transport in World War II, and (10) use as a fuel in a helicopter or a fixed-wing aircraft for purposes of providing transportation with respect to which certain requirements are met. Secs. 4041(f)(2), 4041(g), 4041(h), 4041(l), and 6427(l)(2)(B)(i).

[211] Sec. 9502(d)(2).

[212] Sec. 4081(a)(2)(iii).

[213] Sec. 9503(b)(1)(D).

A special rule of present law addresses whether a removal from a refueler truck, tanker, or tank wagon may be treated as a removal from a terminal for purposes of determining whether aviation-grade kerosene is removed directly into the wing of an aircraft for use in commercial aviation, and so eligible for the 4.3 cents per gallon rate.[214] For the special rule to apply, a qualifying truck, tanker, or tank wagon must be loaded with aviation-grade kerosene from a terminal: (1) that is located within a secured area of an airport, and (2) from which no vehicle licensed for highway use is loaded with aviation fuel, except in exigent circumstances identified by the Secretary in regulations. In order to qualify for the special rule, a refueler truck, tanker, or tank wagon must: (1) be loaded with fuel for delivery only into aircraft at the airport where the terminal is located; (2) have storage tanks, hose, and coupling equipment designed and used for the purposes of fueling aircraft; (3) not be registered for highway use; and (4) be operated by the terminal operator (who operates the terminal rack from which the fuel is unloaded) or by a person that makes a daily accounting to such terminal operator of each delivery of fuel from such truck, tanker, or tank wagon.

### *Explanation of Provision*

The provision imposes the kerosene tax rate of 24.3 cents per gallon upon the entry or removal of aviation-grade kerosene and on the sale of such fuel to any unregistered person unless there was a prior taxable removal or entry of the fuel. The present law reduced rates for removals of aviation-grade kerosene directly into the fuel tank of an aircraft apply,[215] except that in addition, under the provision, if kerosene is removed directly into the fuel tank of an aircraft for use in aviation other than commercial aviation, the rate of tax is 21.8 cents per gallon. In addition, the rate of tax is 21.8 cents per gallon if the kerosene is removed from refueler trucks, tankers, and tank wagons that are loaded with fuel from a terminal that is located in an airport, without regard to whether the terminal is located in a secured area of the airport, as long as all the other requirements of the present law special rule related to such trucks, tankers, and wagons are met. The rate of tax upon removal of kerosene is zero if the removal is from a refueler truck, tanker, or tank wagon that meets all of the requirements of present law, including the security requirement, the kerosene is delivered directly into the fuel tank of an aircraft, and the kerosene is exempt from the tax imposed by section 4041(c) (other than by prior imposition of tax).

The provision provides that amounts may be claimed as credits or refunds for kerosene that is taxed at the 24.3 cents per gallon rate and used for aviation purposes. If kerosene is used for non-

[214] Sec. 4081(a)(3).

[215] For example, for kerosene removed directly into the fuel tank of an aircraft for use in commercial aviation by a person registered for such use, the rate of tax is 4.3 cents per gallon. Kerosene removed directly into the fuel tank of an aircraft for an exempt use is not taxed. For purposes of these reduced rates, it is intended that the following airports be included on the Secretary's list of airports that include a secured area in which a terminal is located. The airports are listed by airport name, and the terminal with respect to the airport is identified by terminal control number: Los Angeles International Airport (T–95–CA–4812) and Federal Express Corporation Memphis Airport (T–62–TN–2220).

commercial aviation, the amount is 2.5 cents; if kerosene is used for commercial aviation, the amount is 20 cents; if kerosene is used for a use that is exempt from tax (as determined under present law), the amount is 24.3 cents. Present law rules with respect to claims apply, except for claims with respect to kerosene used in noncommercial aviation, which may be claimed by the ultimate vendor only.[216] To be eligible to receive a payment, a vendor must be registered and must show either that the price of the fuel did not include the tax and the tax was not collected from the purchaser, the amount of tax was repaid to the ultimate purchaser, or the written consent of the purchaser to the making of the claim was filed with the Secretary.

Under the provision, all taxes collected at the 24.3 cents per gallon rate (under section 4081) initially are credited to the Highway Trust Fund. The provision requires the Secretary to transfer monthly from the Highway Trust Fund to the Airport and Airway Trust Fund amounts equivalent to 21.8 cents per gallon for claims made with respect to kerosene used for noncommercial aviation purposes, 4.3 cents per gallon for claims made with respect to kerosene used for commercial aviation purposes, and the amounts attributable to taxes received with respect to amounts allowed as a credit under section 34 for kerosene used for aviation purposes. The provision requires that transfers be made on the basis of estimates by the Secretary, with proper adjustments to be made subsequently to the extent prior estimates were in excess of or less than the amounts required to be transferred. The provision provides that the Airport and Airway Trust Fund does not reimburse the General Fund for claims with respect to kerosene that is taxed at the 24.3 cents per gallon rate and used for aviation purposes, or with respect to credits allowed under section 34 to the extent the Highway Trust Fund is credited initially with the amount of tax with respect to which the credit is claimed. Transfers are required to be made with respect to taxes received on or after October 1, 2005, and before October 1, 2011.

### *Effective Date*

The provision is effective for fuels or liquids removed, entered, or sold after September 30, 2005.

## B. Repeal of Ultimate Vendor Refund Claims with Respect to Farming (sec. 11162 of the Act and sec. 6427(l) of the Code)

### *Present Law*

#### *In general—ultimate purchaser refunds for nontaxable uses*

In general, the Code provides that if diesel fuel or kerosene on which tax has been imposed is used by any person in a nontaxable use, the Secretary is to refund (without interest) to the ultimate purchaser the amount of tax imposed.[217] The refund is made to the ultimate purchaser of the taxed fuel by either income tax credit or

[216] These rules were subsequently clarified in Division A, section 420 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

[217] Sec. 6427(l)(1).

refund payment.[218] Not more than one claim may be filed by any person with respect to fuel used during its taxable year. However, there are exceptions to this rule.

An ultimate purchaser may make a claim for a refund payment for any quarter of a taxable year for which the purchaser can claim at least $750.[219] If the purchaser cannot claim at least $750 at the end of quarter, the amount can be carried over to the next quarter to determine if the purchaser can claim at least $750. If the purchaser cannot claim at least $750 at the end of the taxable year, the purchaser must claim a credit on the person's income tax return.

As discussed below, these ultimate purchaser refund rules do not apply to diesel fuel or kerosene used on a farm. The Code precludes the ultimate purchaser from claiming a refund for such use. Instead, the refund claims are made by registered vendors as described below.

***Special vendor rule for use on a farm for farming purposes***

In the case of diesel fuel or kerosene used on a farm for farming purposes refund payments are paid to the ultimate, registered vendors ("registered ultimate vendor") of such fuels. Thus a registered ultimate vendor that sells undyed diesel fuel or undyed kerosene to any of the following may make a claim for refund: (1) the owner, tenant, operator of a farm for use by that person on a farm for farming purposes; and (2) a person other than the owner, tenant, or operator of a farm for use by that person on a farm in connection with cultivating, raising or harvesting. The registered ultimate vendor is the only person who may make the claim with respect to diesel fuel or kerosene used on a farm for farming purposes. The purchaser of the fuel cannot make the claim for refund.

Registered ultimate vendors may make weekly claims if the claim is at least $200 ($100 or more in the case of kerosene).[220] If not paid within 45 days (20 days for an electronic claim), the Secretary is to pay interest on the claim.

### *Explanation of Provision*

The provision repeals ultimate vendor refund claims in the case of diesel fuel or kerosene used on a farm for farming purposes. Thus, refunds for taxed diesel fuel or kerosene used on a farm for farming purposes would be paid to the ultimate purchaser under the rules applicable to nontaxable uses of diesel fuel or kerosene.

### *Effective Date*

The provision is effective for sales after September 30, 2005.

---

[218] Generally, refund payments are only made to governmental units and tax-exempt organizations. Sec. 6427(k). The quarterly payment claim rules for ultimate purchasers are an exception to this rule.

[219] Sec. 6427(i)(2).

[220] See 6427(i)(4)(A).

## C. Refunds of Excise Taxes on Exempt Sales of Taxable Fuel by Credit Card (sec. 11163 of the Act and secs. 6206, 6416, 6427, and 6675 of the Code)

### *Present Law*

Under the rules in effect prior to 2005, in the case of gasoline on which tax had been paid and sold to a State or local government, to a nonprofit educational organization, for supplies for vessels or aircraft, for export, or for the production of special fuels, the wholesale distributor that sold such gasoline was treated as the only person who paid the tax and thereby was the proper claimant for a credit or refund of the tax paid. A "wholesale distributor" included any person, other than an importer or producer, who sold gasoline to producers, retailers, or to users who purchased in bulk quantities and accepted delivery into bulk storage tanks. A wholesale distributor also included any person who made retail sales of gasoline at 10 or more retail motor fuel outlets.

Under a special administrative exception to these rules, a sale of gasoline charged on an oil company credit card issued to an exempt person described above is not considered a direct sale by the person actually selling the gasoline to the ultimate purchaser if the seller receives a reimbursement of the tax from the oil company (or indirectly through an intermediate vendor). Thus, the person that actually paid the tax, in most cases the oil company, is treated as the only person eligible to make the refund claim.[221]

The American Jobs Creation Act of 2004 ("AJCA")[222] modified the pre-existing statutory rules with respect to certain sales. Under AJCA, if a registered ultimate vendor purchases any gasoline on which tax has been paid and sells such gasoline to a State or local government or to a nonprofit educational organization, for its exclusive use, such ultimate vendor is treated as the only person who paid the tax and thereby is the proper claimant for a credit or refund of the tax paid.[223] However, AJCA did not change the special administrative oil company credit card rule described above.[224]

In addition, under AJCA, refund claims made by such an ultimate vendor may be filed for any period of at least one week for which $200 or more is payable. Any such claim must be filed on or before the last day of the first quarter following the earliest quarter included in the claim. The Secretary must pay interest on refunds unpaid after 45 days. If the refund claim was filed by electronic means, and the ultimate vendor has certified to the Secretary for the most recent quarter of the taxable year that all ultimate purchasers of the vendor are certified for highway exempt use as a State or local government or a nonprofit educational organization, refunds unpaid after 20 days must be paid with interest.[225]

---

[221] Notice 89–29, 1989–1 C.B. 669.

[222] Pub. L. No. 108–357.

[223] AJCA, sec. 865(a), effective January 1, 2005. See Code sec. 6416(a)(4)(A).

[224] In Notice 2005–4, 2005–2 I.R.B. 289, the Treasury Department confirmed that it would continue to apply the oil company credit card rule until March 1, 2005. On February 28, 2005, the Treasury Department issued Notice 2005–24, 2005–12 I.R.B. 1, modifying Notice 2005–4. Notice 2005–24 stated that the oil company credit card rule will remain in effect until it is modified by a statutory change or by future guidance.

[225] Sec. 6416(a)(4)(B).

In the case of diesel fuel or kerosene used in a nontaxable use, the ultimate purchaser is generally the only person entitled to claim a refund of excise tax.[226] However, in the case of diesel fuel or kerosene used on a farm for farming purposes or by a State or local government, aviation-grade kerosene, and certain nonaviation-grade kerosene, an ultimate vendor may claim the refund if the ultimate vendor is registered and bears the tax (or receives the written consent of the ultimate purchaser to claim the refund).[227]

### *Explanation of Provision*

The provision replaces the oil company credit card rule with a new set of rules applicable to certain credit card sales. The new rules apply to all taxable fuels. Under the provision, if a purchase of taxable fuel is made by means of a credit card issued to an ultimate purchaser that is either a State or local government or, in the case of gasoline, a nonprofit educational organization, for its exclusive use, a credit card issuer who is registered and who extends such credit to the ultimate purchaser with respect to such purchase shall be the only person entitled to apply for a credit or refund if the following two conditions are met: (1) such registered person has not collected the amount of the tax from the purchaser, or has obtained the written consent of the ultimate purchaser to the allowance of the credit or refund; and (2) such registered person has either repaid or agreed to repay the amount of the tax to the ultimate vendor, has obtained the written consent of the ultimate vendor to the allowance of the credit or refund, or has otherwise made arrangements that directly or indirectly provide the ultimate vendor with reimbursement of such tax. It is anticipated that such indirect arrangements may consist of the contractual undertaking of the relevant oil company to the credit card issuer that it will pay the amount of the tax to the ultimate vendor, and the corresponding contractual undertaking of the oil company to the ultimate vendor.

A credit card issuer entitled to claim a refund under the provision is responsible for collecting and supplying all the appropriate documentation currently required from ultimate vendors. The present-law refund amount and timing rules applicable to ultimate vendors, including the special rules for electronic claims, apply to refunds to credit card issuers under the provision.[228]

Under the provision, if a credit card issuer is not registered, or if either condition (1) or (2) described above is not met (or if the ultimate purchaser is not exempt), then the credit card issuer is required to collect an amount equal to the tax from the ultimate purchaser and only an (exempt) ultimate purchaser may claim a credit or payment from the IRS.[229] Congress intends that tax-paid fuel shall not be sold tax free to an exempt entity by means of a credit card unless the credit card issuer is registered. An unregistered credit card issuer that does not collect an amount equal to the tax

[226] Sec. 6427(l)(1).

[227] See. sec. 6427(l)(4)(B), and (l)(5)(B), and (l)(5)(C), and sec. 6416(a)(1)(A), (B), and (D).

[228] See sec. 6416(a)(4)(B). Present law would continue to apply to the timing of ultimate purchaser claims. Under present law, claims by an ultimate purchaser are generally made on an annual basis. However, claims aggregating over $750 may be made quarterly. See secs. 6421(d) and 6427(i)(2).

[229] See sec. 6421(c).

from the exempt entity is liable for present-law penalties for failure to register.[230] The present-law regulatory authority of the Secretary to prescribe the form, manner, terms, conditions of registration, and conditions of use of registration extends to registration under this provision.[231] Such authority may include rules that preclude persons which are registered credit card issuers from issuing nonregistered credit cards.[232] Congress also intends that the IRS will review the registration of a registered credit card issuer that has engaged in multiple or flagrant violations of the requirements of the provision.

The provision also conforms present-law penalty provisions to the new rules.

The provision does not change the present-law rules applicable to non-credit card purchases.

### *Effective Date*

The provision is effective for sales after December 31, 2005.

## D. Reregistration in Event of Change in Ownership (sec. 11164 of the Act and secs. 4101, 6719, 7232, and 7272 of the Code)

### *Present Law*

Blenders, enterers, pipeline operators, position holders, refiners, terminal operators, and vessel operators are required to register with the Secretary with respect to fuels taxes imposed by sections 4041(a)(1) and 4081.[233] An assessable penalty for failure to register is $10,000 for each initial failure, plus $1,000 per day that the failure continues.[234] A nonassessable penalty for failure to register is $10,000.[235] A criminal penalty of $10,000, or imprisonment of not more than five years, or both, together with the costs of prosecution also applies to a failure to register and to certain false statements made in connection with a registration application.[236] Treasury regulations require that a registrant notify the Secretary of any change (such as a change in ownership) in the information a registrant submitted in connection with its application for registration within 10 days of the change.[237] The Secretary has the discretion to revoke the registration of a noncompliant registrant.

### *Explanation of Provision*

The provision requires that upon a change in ownership of a registrant, the registrant must reregister with the Secretary, as provided by the Secretary. A change in ownership means that after a transaction (or series of related transactions), more than 50 percent of the ownership interests in, or assets of, a registrant are held by

---

[230] See secs. 6719, 7232, and 7272.
[231] Sec. 4101(a)(1).
[232] Because registration occurs at the "person" (legal entity) level, it is anticipated that a credit card issuer will use a separate (registered) entity for the issuance of credit cards entitled to the benefits of this provision.
[233] Sec. 4101; Treas. Reg. secs. 48.4101–1(a) and 48.4101–1(c)(1).
[234] Sec. 6719.
[235] Sec. 7272(a).
[236] Sec. 7232.
[237] Treas. Reg. sec. 48.4101–1(h)(1)(v).

persons other than persons (or persons related thereto) who held more than 50 percent of such interests or assets before the transaction (or series of related transactions). The provision does not apply to companies, the stock of which is regularly traded on an established securities market. There is an assessable penalty for failure to reregister of $10,000 for each initial failure, plus $1,000 per day that the failure continues, a nonassessable penalty for failure to reregister of $10,000, and a criminal penalty for failure to reregister of $10,000, or imprisonment of not more than five years, or both, together with the costs of prosecution. The provision applies to changes in ownership occurring prior to, on, or after the date of enactment.

### *Effective Date*

The provision is effective for actions or failures to act after the date of enactment (August 10, 2005).

## E. Reconciliation of On-Loaded Cargo to Entered Cargo (sec. 11165 of the Act and sec. 343 of the Trade Act of 2002)

### *Present Law*

The Trade Act of 2002 directed the Secretary to promulgate regulations pertaining to the electronic transmission to the Bureau of Customs and Border Patrol ("Customs") of information pertaining to cargo destined for importation into the United States or exportation from the United States, prior to such importation or exportation.[238] The Department of the Treasury issued final regulations on October 31, 2002. The regulations require the advance and accurate presentation of certain manifest information prior to lading at the foreign port and encourage the presentation of this information electronically. Customs must receive from the carrier the vessel's Cargo Declaration (Customs Form 1302) or the electronic equivalent within 24 hours before such cargo is laden aboard the vessel at the foreign port.[239]

Certain carriers of bulk cargo, however, are exempt from these filing requirements. Such bulk cargo includes that composed of free flowing articles such as oil, grain, coal, ore and the like, which can be pumped or run through a chute or handled by dumping.[240] Thus, taxable fuels are not required to file the Cargo Declaration within 24 hours before such cargo is laden aboard the vessel at the foreign port. Instead the Cargo Declaration must be filed within 24 hours prior arrival in the United States.

### *Explanation of Provision*

The provision provides that not later than one year after the date of enactment of this paragraph, the Secretary of Homeland Security, together with the Secretary of the Treasury, is to establish an electronic data interchange system through which Customs shall transmit to the Internal Revenue Service information pertaining to cargoes of taxable fuels (as defined in section 4083) that Customs

[238] Sec. 343(a) of Pub. L. No. 107–210 (2002).
[239] 19 CFR sec. 4.7(b)(2).
[240] 19 CFR sec. 4.7(b)(4)(i)(A).

has obtained electronically under its regulations adopted to carry out the Trade Act of 2002 requirement. For this purpose, not later than one year after the date of enactment, all filers of required cargo information for such taxable fuels, as defined, must provide such information to Customs through its approved electronic data interchange system.

### *Effective Date*

The provision is effective upon date of enactment (August 10, 2005).

## F. Treatment of Deep-Draft Vessels (sec. 11166 of the Act and secs. 4081 and 4101 of the Code)

### *Present Law*

Blenders, enterers, pipeline operators, position holders, refiners, terminal operators, and vessel operators are required to register with the Secretary with respect to fuels taxes imposed by sections 4041(a)(1) and 4081.[241] Treasury regulations define a vessel operator as any person that operates a vessel within the bulk transfer/terminal system, excluding deep-draft ocean-going vessels.[242] Accordingly, operators of deep-draft ocean-going vessels are not required to register. A deep-draft ocean-going vessel is a vessel that is designed primarily for use on the high seas that has a draft of more than 12 feet.[243]

An assessable penalty for failure to register is $10,000 for each initial failure, plus $1,000 per day that the failure continues.[244] A nonassessable penalty for failure to register is $10,000.[245] A criminal penalty of $10,000, or imprisonment of not more than five years, or both, together with the costs of prosecution also applies to a failure to register and to certain false statements made in connection with a registration application.[246]

In general, gasoline, diesel fuel, and kerosene ("taxable fuel") are taxed upon removal from a refinery or a terminal.[247] Tax also is imposed on the entry into the United States of any taxable fuel for consumption, use, or warehousing. The tax does not apply to any removal or entry of a taxable fuel transferred in bulk (a "bulk transfer") by pipeline or vessel to a terminal or refinery if the person removing or entering the taxable fuel, the operator of such pipeline or vessel, and the operator of such terminal or refinery are registered with the Secretary as required by section 4101.[248] Transfer to an unregistered party subjects the transfer to tax.

### *Explanation of Provision*

The provision provides that the Secretary of the Treasury shall require the registration of every operator of a deep-draft ocean

[241] Sec. 4101; Treas. Reg. sec. 48.4101–1(a) and 48.4101–1(c)(1).
[242] Treas. Reg. sec. 48.4101–1(b)(8).
[243] Sec. 4042(c)(1).
[244] Sec. 6719.
[245] Sec. 7272(a).
[246] Sec. 7232.
[247] Sec. 4081(a)(1)(A).
[248] Sec. 4081(a)(1)(B). The sale of a taxable fuel to an unregistered person prior to a taxable removal or entry of the fuel is subject to tax. Sec. 4081(a)(1)(A).

going vessel, unless such operator uses such vessel exclusively for purposes of the entry of the taxable fuel. Under the provision, if a deep-draft ocean-going vessel is used as part of a bulk transfer of taxable fuel (other than for entry), the transfer is subject to tax unless the operator of such vessel is registered.

### *Effective Date*

The provision is effective on the date of enactment (August 10, 2005).

## G. Impose Assessable Penalty on Dealers of Adulterated Fuel (sec. 11167 of the Act and new sec. 6720A of the Code)

### *Present Law*

Diesel fuel, gasoline, and kerosene are taxable fuels. Diesel fuel is defined as (1) any liquid (other than gasoline) which is suitable for use as a fuel in a diesel-powered highway vehicle or a diesel powered train, (2) transmix, and (3) diesel fuel blend stocks identified by the Secretary.[249] As a defense to Federal and State excise tax liability, some taxpayers have contended that certain diesel fuel mixtures or additives do not meet the requirements of (1) above because they are not approved as additives or mixtures by the EPA. In addition, under present law, untaxed fuel additives, including certain contaminants, may displace taxed diesel fuel in a mixture.

The Code provides that any person who, in connection with a sale or lease (or offer for sale or lease) of an article, knowingly makes any false statement ascribing a particular part of the price of the article to a tax imposed by the United States, or intended to lead any person to believe that any part of the price consists of such a tax, is guilty of a misdemeanor.[250] Another Code provision provides that any person who has in his custody or possession any article on which taxes are imposed by law, for the purpose of selling the article in fraud of the internal revenue laws or with design to avoid payment of the taxes thereon, is liable for "a penalty of $500 or not less than double the amount of taxes fraudulently attempted to be evaded."[251]

### *Explanation of Provision*

The provision adds a new assessable penalty. Any person other than a retailer who knowingly transfers for resale, sells for resale, or holds out for resale for use in a diesel-powered highway vehicle (or train) any liquid that does not meet applicable EPA regulations (as defined in section 45H(c)(3)[252] is subject to a penalty of $10,000 for each such transfer, sale or holding out for resale, in addition to the tax on such liquid, if any. Any retailer who knowingly holds out for sale (other than for resale) any such liquid, is subject to a

[249] Sec. 4083(a)(3)(A).

[250] Sec. 7211. Such a violation is punishable by a fine not to exceed $1,000, or by imprisonment for not more than one year, or both.

[251] Sec. 7268.

[252] Section 45H(c)(3) refers to "the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency."

$10,000 penalty for each such holding out for sale, in addition to the tax on such liquid, if any.

The penalty is dedicated to the Highway Trust Fund.

### *Effective Date*

The provision is effective for any transfer, sale, or holding out for sale or resale occurring after the date of enactment (August 10, 2005).

## V. FUELS-RELATED TECHNICAL CORRECTIONS

### A. Fuels-Related Technical Corrections to American Jobs Creation Act of 2004 ("AJCA")

The provision includes technical corrections to AJCA. Such technical corrections take effect as if included in the section of AJCA to which the correction relates.

#### 1. Volumetric ethanol excise tax credit (sec. 11151(a) of the Act, sec. 301 of AJCA, and sec. 6427 of the Code)

AJCA repealed the reduced tax rates for alcohol fuels and taxable fuels to be blended with alcohol. The technical correction makes a conforming amendment to eliminate the refund provisions based on those reduced rates (secs. 6427(f) and 6427(o)).

#### 2. Aviation fuel (sec. 11151(b) of the Act, sec. 853 of AJCA, and sec. 4081 of the Code)

Section 853 of AJCA moved the taxation of jet fuel (aviation-grade kerosene) from section 4091 to section 4081 of the Code and repealed section 4091. The termination date for the 21.8 cent per gallon rate for noncommercial aviation jet fuel was inadvertently omitted from the Act. The technical correction clarifies that after September 30, 2007, the rate for jet fuel used in noncommercial aviation will be 4.3 cents per gallon (sec. 4081(a)(2)(C)).

An additional technical correction clarifies that users of aviation fuel in commercial aviation are required to be registered with the IRS in order for the 4.3-cents-per-gallon rate to apply (including for purposes of the self-assessment of tax by commercial aircraft operators). The provision also corrects cross-references in section 6421(f)(2) to the definition of noncommercial aviation to reflect changes made by the AJCA change in the tax treatment of fuel used in aviation.

### B. Fuels-Related Technical Corrections to Transportation Equity Act for the 21st Century ("TEA 21")

The provision includes a technical correction to TEA 21. The amendment made by the technical correction takes effect as if included in the section of TEA 21 to which it relates.

#### 1. Coastal Wetlands sub-account (sec. 11151(c) and (d) of the Act, sec. 9005 of TEA 21, and sec. 9504 of the Code)

Section 9005(b)(3) of TEA 21 redesignated Code section 9504(b)(2)(B), referring to the purposes of the Coastal Wetlands Planning, Protection and Restoration Act, as 9504(b)(2)(C), but did not cross reference the limitation for such purposes of taxes on gasoline used in the nonbusiness use of small-engine outdoor power

equipment. The technical correction makes a conforming cross-reference amendment (sec. 9504(b)(2)).

### C. Correction to the Energy Tax Incentives Act of 2005

The provision includes a technical correction to the Energy Tax Incentives Act ("ETIA") of 2005. The amendment made by the technical correction takes effect as if included in the section of the ETIA to which it relates.

#### 1. Erroneous reference to highway reauthorization bill (sec. 11151(f) of the Act and sec. 38 of the Code)

The provision corrects an erroneous reference to the highway reauthorization bill in section 38 as added by the Energy Policy Act of 2005.

## PART SEVEN: KATRINA EMERGENCY TAX RELIEF ACT OF 2005 (PUBLIC LAW 109–73)[253]

## DEFINITION OF "HURRICANE KATRINA DISASTER AREA" AND "CORE DISASTER AREA" (sec. 2 of the Act)

### *General Definitions*

For purposes of the Act the following definitions apply. 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. The States for which such a disaster has been declared are Alabama, Florida, Louisiana, and Mississippi. 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.

[253] H.R. 3768. The House passed the bill on the suspension calendar on September 15, 2005. The Senate passed the bill with an amendment by unanimous consent on September 15, 2005. The House agreed to the Senate amendment with an amendment on September 21, 2005. The Senate agreed to the House amendment by unanimous consent on September 21, 2005. The President signed the bill on September 23, 2005. For a technical explanation of the bill prepared by the staff of the Joint Committee on Taxation, see *Joint Committee on Taxation, Technical Explanation of H.R. 3768, the "Katrina Emergency Tax Relief Act of 2005" as Passed by the House and the Senate on September 21, 2005* (JCX–69–05), September 22, 2005.

## TITLE I—SPECIAL RULES FOR USE OF RETIREMENT FUNDS FOR RELIEF RELATING TO HURRICANE KATRINA

### A. Tax-Favored Withdrawals from Retirement Plans for Relief Relating to Hurricane Katrina (sec. 101 of the Act)

#### *Present Law*

Under present law, a distribution from a qualified retirement plan, a tax-sheltered annuity (a "403(b) annuity"), an eligible deferred compensation plan maintained by a State or local government (a "governmental 457 plan"), or an individual retirement arrangement (an "IRA") generally is included in income for the year distributed (secs. 402(a), 403(b), 408(d), 457(a)). (These plans are referred to collectively as "eligible retirement plans".) In addition, a distribution from a qualified retirement plan, a 403(b) annuity, or an IRA received before age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception applies (sec. 72(t)).

An eligible rollover distribution from a qualified retirement 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 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 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 59½, death, disability, or financial hardship of the employee. Amounts deferred under a governmental 457 plan may not be distributed before severance from employment, age 70½, or an unforeseeable emergency of the employee.

#### *Explanation of Provision*

The provision provides an exception to the 10-percent early withdrawal tax in the case of a qualified Hurricane Katrina distribution from a qualified retirement 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.

Under the provision, 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.

Under the provision, 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.

### *Effective Date*

The provision is effective on the date of enactment (September 23, 2005).

## B. Recontributions of Withdrawals for Home Purchases Cancelled Due to Hurricane Katrina (sec. 102 of the Act)

### *Present Law*

Under present law, a distribution from a qualified retirement plan, a tax-sheltered annuity (a "403(b) annuity"), or an individual retirement arrangement (an "IRA") generally is included in income for the year distributed (secs. 402(a), 403(b), and 408(d)). In addition, a distribution from a qualified retirement plan, a 403(b) annuity, or an IRA received before age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception applies (sec. 72(t)). An exception to the 10-percent tax applies in the case of a qualified first-time homebuyer distribution from an IRA, i.e., a distribution (not to exceed $10,000) used within 120 days for the purchase or construction of a principal residence of a first-time homebuyer.

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

Certain amounts held in a qualified retirement plan that includes a qualified cash-or- deferred arrangement (a "401(k) plan") or a 403(b) annuity may not be distributed before severance from employment, age 59½, 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.

### *Explanation of Provision*

In general, under the provision, 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 provision 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.

Under the provision, 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).

### *Effective Date*

The provision is effective on the date of enactment (September 23, 2005).

## C. Loans from Qualified Plans for Relief Relating to Hurricane Katrina (sec. 103 of the Act)

### *Present Law*

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 tax-deferred annuity under section 403(a) or 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.

### *Explanation of Provision*

The provision provides special rules in the case of a loan from a qualified employer plan to a qualified individual made after the date of enactment 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.

Under the provision, 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.

Under the provision, 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.

### *Effective Date*

The provision is effective on the date of enactment (September 23, 2005).

## D. Plan Amendments in Connection with Hurricane Katrina (sec. 104 of the Act)

### *Present Law*

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

### *Explanation of Provision*

The provision permits certain plan amendments made pursuant to the changes made by the provisions of Title I of the Act, or regulations issued thereunder, to be retroactively effective. If the plan amendment meets the requirements of the provision, then the plan will be treated as being operated in accordance with its terms. In

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

### *Effective Date*

The provision is effective on the date of enactment (September 23, 2005).

## TITLE II—EMPLOYMENT RELIEF

### A. Work Opportunity Tax Credit for Hurricane Katrina Employees (sec. 201 of the Act)

#### *Present Law*

***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.

***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.

***Certification requirement***

In general, an individual is not treated as a member of a targeted group unless (1) on or before the day on which such individual begins work for the employer, the employer has received a certification from a designated local agency that such individual is a member of a targeted group or (2) on or before the day the individual is offered employment with the employer, a pre-screening notice is completed by the employer with respect to such individual and not later than the twenty-first day after the individual begins

work for the employer, the employer submits such notice, signed by the employer and the individual under the penalties of perjury, to the designated local agency as part of a written request for such a certification from such agency.

***Qualifying rehires***

No credit is available for any individual if, prior to the hiring date of such individual, such individual had been employed by the employer at any time.

***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 for which the employer claims the welfare-to-work tax credit.

***Other rules***

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

***Expiration date***

The work opportunity tax credit is effective for wages paid or incurred to a qualified individual who begins work for an employer before January 1, 2006.

## *Explanation of Provision*

The provision provides that a Hurricane Katrina employee is treated as a member of a targeted group for purposes of the work opportunity tax credit. A Hurricane Katrina employee is: (1) an individual who on August 28, 2005, had a principal place of abode in the core disaster area and is hired during the two-year period beginning on such date for a position, the principal place of employment of which is located in the core disaster area; and (2) an individual who on August 28, 2005, had a principal place of abode in the core disaster area, who was displaced from such abode by reason of Hurricane Katrina and is hired during the period beginning on such date and ending on December 31, 2005 without regard to whether the new principal place of employment is in the core disaster area.

The present-law WOTC certification requirement is waived for such individuals. In lieu of the certification requirement, an individual may provide to the employer reasonable evidence that the individual is a Hurricane Katrina employee.

The present-law rule that denies the credit with respect to wages of employees who had been previously employed by the employer is waived for the first hire of such employee as a Hurricane

Katrina employee unless such employee was an employee of the employer on August 28, 2005.

The present-law work opportunity tax credit expiration date is waived for purposes of Hurricane Katrina employee employees.

### *Effective Date*

The provision is effective on the date of enactment (September 23, 2005).

## B. Employee Retention Credit for Employers Affected by Hurricane Katrina (sec. 202 of the Act)

### *Present Law*

There is no employer tax credit for wages paid solely by reason of such wages being paid by employers in connection with a disaster area.

### *Explanation of Provision*

The provision provides a credit of 40 percent of the qualified wages (up to a maximum of $6000 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.

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.

### *Effective Date*

The provision is effective on the date of enactment (September 23, 2005).

## TITLE III—CHARITABLE GIVING INCENTIVES

### A. Temporary Suspension of Limitations on Charitable Contributions (sec. 301 of the Act)

#### *Present Law*

***In general***

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

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

***Percentage limitations***

*Contributions by individuals*

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

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

Contributions of appreciated capital gain property to charitable organizations described in section 170(b)(1)(A) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of appreciated capital gain property for a taxable year within the 50-

percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of appreciated capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private nonoperating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

*Contributions by corporations*

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

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

*Carryforward of excess contributions*

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

***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.

## *Explanation of Provision*

***Suspension of percentage limitations***

Under the provision, in the case of an individual, the deduction for qualified contributions is allowed up to the amount by which the taxpayer's contribution base exceeds the deduction for other charitable contributions. Contributions in excess of this amount are carried over to succeeding taxable years as contributions described

in section 170(b)(1)(A), subject to the limitations of section 170(d)(1)(A)(i) and (ii).

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

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

Qualified contributions are cash contributions made during the period beginning on August 28, 2005, and ending on December 31, 2005, to a charitable organization described in section 170(b)(1)(A) (other than a supporting organization described in section 509(a)(3)). Contributions of noncash property, such as securities, are not qualified contributions. Under the provision, qualified contributions must be to an organization described in section 170(b)(1)(A); thus, contributions to, for example, a charitable remainder trust generally are not qualified contributions, unless the charitable remainder interest is paid in cash to an eligible charity during the applicable time period. In the case of a corporation, qualified contributions must be for relief efforts related to Hurricane Katrina. 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. For example, a segregated fund or account exists if a donor makes a charitable contribution and the donee separately identifies the donor's contribution on its books by reference to the donor. The donor has advisory privileges with respect to such segregated fund or account if the donor, by written agreement or otherwise, is permitted to provide advice to the donee as to the investment or distribution of amounts from such fund or account. In addition, a segregated fund or account also includes, but is not limited to, a separate bank account or trust established or maintained by a donee; however, in order for a contribution to such account or fund necessarily to be not a qualified contribution, the donor (or a person appointed or designated by the donor) must have or reasonably expect to have advisory privileges as to the investment or distribution of amounts in such account or fund. For instance, a donor reasonably expects to have advisory privileges with respect to contributions made by the donor if the donor understands that the donee will consider advice provided by the donor (or a person appointed or designated by the donor) in making investments or distributions. It is intended that a person shall not be treated as having advisory privileges by virtue of having a legal or contractual right or obligation, or a fidu-

ciary duty, with respect to a segregated fund or account. If a donor makes a contribution for establishment of a new, or maintenance in an existing, segregated account or fund, and the donor also provides advice with respect to amounts in such account or fund by reason of the donor's position as an officer, employee, or director of the donee, and not by reason of the donor's status as a donor, then, under the provision, the donor is not treated as having or reasonably expecting to have advisory privileges with respect to such fund or account. However, if by reason of a donor's charitable contribution to a segregated account or fund, the donor secured, for example, an appointment on a committee of the donee organization that advised how to distribute or invest amounts in such account or fund, the contribution would not be a qualified contribution notwithstanding that the donor is an officer, employee, or director of the donee organization.

Below are examples illustrating the operation of the provision. (The examples assume the taxpayer makes an election to have the provision apply.)

*Example 1.*—Assume individual A's contribution base for 2005 is $100,000; aggregate qualified contributions are $70,000; and other charitable contributions to organizations described in section 170(b)(1)(A) are $60,000. Under the provision, A is allowed a deduction of $100,000 for 2005 ($50,000 determined without regard to qualified contributions plus $50,000 for the qualified contributions). $30,000 is treated as a contribution described in section 170(b)(1)(A) paid in each of the five succeeding taxable years (subject to the limitations of section 170(d)(1)(A)(i) and (ii)). $30,000 is the sum of the $10,000 excess referred to in section 170(d)(1)(A) (the excess of $60,000 over $50,000) and the $20,000 excess referred to in section 301(b)(1)(B) of the Act (the excess of $70,000 over $50,000).

*Example 2.*—For calendar year 2005, B, an individual, has a contribution base of $100,000. On January 10, 2005, B makes a $7,000 cash contribution to an organization described in section 170(b)(1)(A) and a $65,000 cash charitable contribution to an organization not so described. On October 10, 2005, B makes a $70,000 qualified contribution. In 2004, B made charitable contributions to organizations described in section 170(b)(1)(A) that exceeded 50% of the contribution base by $5,000.

First, subsections (b) and (d) of section 170 are applied by disregarding the qualified contribution. For 2005, a $12,000 deduction is allowed under section 170(b)(1)(A)—the $7,000 current year contribution and the $5,000 carryover from 2004. For 2005, a $30,000 deduction for the contribution to the organization not described in section 170(b)(1)(A) also is allowed. This amount is the lesser of (i) $38,000 ($50,000 (50% of B's contribution base) less the $12,000 allowed under section 170(b)(1)(A)) or (ii) $30,000 (30 percent of B's contribution base). The remaining contribution amount of $35,000 is carried over as a contribution to an organization which is not described in section 170(b)(1)(A). Thus, without regard to the qualified contribution, B is allowed a total contribution deduction of $42,000 in 2005.

In addition, B may deduct $58,000 of the qualified contribution in 2005 (the lesser of (i) the $70,000 amount of the qualified con-

tribution or (ii) the $58,000 excess of B's $100,000 contribution base over the $42,000 amount otherwise deductible). $12,000 is treated as a contribution described in section 170(b)(1)(A) paid in each of the five succeeding taxable years (subject to the limitations of section 170(d)(1)(A)(i) and (ii)).

In summary, B's deduction for 2005 is $100,000; $12,000 may be carried over as a contribution to an organization described in section 170(b)(1)(A) (subject to the limitations of section 170(d)(1)(A)(i) and (ii)); and $35,000 may be carried over as a contribution to an organization not so described (subject to similar limitations).

*Example 3.*—Assume corporation X's taxable income (as defined in section 170(b)(2)) for 2005 is $100,000; aggregate qualified contributions (which, in the case of a corporation, must be related to Hurricane Katrina relief efforts) are $100,000; and other charitable contributions are $20,000. Under the provision, X is allowed a deduction of $100,000 for 2005 ($10,000 determined without regard to qualified contributions plus $90,000 for the qualified contributions). $20,000 is deductible in each of the five succeeding taxable years (subject to the limitations of section 170(d)(2)(A)(i) and (ii)). $20,000 is the sum of the $10,000 excess referred to in section 170(d)(2)(A) (the excess of $20,000 over $10,000) and the $10,000 excess referred to in section 301(b)(2)(B) of the Act (the excess of $100,000 over $90,000).

### *Limitation on overall itemized deductions*

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

### *Effective Date*

The provision is effective on the date of enactment (September 23, 2005).

## B. Additional Personal Exemption for Housing Hurricane Katrina Displaced Individuals (sec. 302 of the Act)

### *Present Law*

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 if filing jointly, 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.

### *Explanation of Provision*

The provision provides an additional exemption of $500 for each Hurricane Katrina displaced individual of the taxpayer. The taxpayer may claim the additional exemption for no more than four individuals. Thus, the maximum additional exemption amount is $2,000. The provision applies only for taxable years beginning in 2005 and 2006; however, the exemption with respect to any Hurricane Katrina displaced individual may be claimed only one time for all taxable years.

A Hurricane Katrina displaced individual is a person (1) whose principal place of abode on August 28, 2005 was in the Hurricane Katrina disaster area, (2) who is displaced from such abode, and (3) who is provided housing free of charge in the taxpayer's principal residence for a period of 60 consecutive days which ends in the taxable year in which the exemption is claimed. Additionally, in the case of a person whose principal place of abode on August 28, 2005 was located outside of the core disaster area, in order to qualify as a displaced individual such person's abode must have been damaged by Hurricane Katrina or such person must have been evacuated from such abode by reason of Hurricane Katrina. A Hurricane Katrina displaced individual may not be the spouse or any dependent of the taxpayer. In order to claim the additional exemption, the taxpayer must provide the taxpayer identification number of the displaced individual. Additionally, the exemption is not allowed if the taxpayer receives any rent or other amount from any source in connection with the providing of housing for a displaced individual.

The additional exemption is not subject to the income-based phaseouts applicable to personal exemptions, and is allowed as a deduction in computing alternative minimum taxable income.

### *Effective Date*

The provision is effective on the date of enactment (September 23, 2005).

## C. Increase in Standard Mileage Rate for Charitable Use of Vehicles (sec. 303 of the Act)

### *Present Law*

In general, an itemized deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of

taxpayer, the property contributed, and the donee organization. Unreimbursed out-of-pocket expenditures made incident to providing donated services to a qualified charitable organization—such as out-of-pocket transportation expenses necessarily incurred in performing donated services—may qualify as a charitable contribution (Treasury Regulation sec. 1.170A–1(g)). No charitable contribution deduction is allowed for traveling expenses (including expenses for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel (sec. 170(j)).

In determining the amount treated as a charitable contribution where a taxpayer operates a vehicle in providing donated services to a charity, the taxpayer either may deduct actual out-of-pocket expenditures or, in the case of a passenger automobile, may use the charitable standard mileage rate. The charitable standard mileage rate is set by statute at 14 cents per mile (sec. 170(i)). The taxpayer may also deduct (under either computation method), any parking fees and tolls incurred in rendering the services, but may not deduct any amount (regardless of the computation method used) for general repair or maintenance expenses, depreciation, insurance, registration fees, etc. Regardless of the computation method used, the taxpayer must keep reliable written records of expenses incurred. For example, where a taxpayer uses the charitable standard mileage rate to determine a deduction, the IRS has stated that the taxpayer generally must maintain records of miles driven, time, place (or use), and purpose of the mileage. If the charitable standard mileage rate is not used to determine the deduction, the taxpayer generally must maintain reliable written records of actual expenses incurred.

In lieu of actual operating expenses, an optional standard mileage rate may be used in computing the deductible costs of business use of an automobile. The business standard mileage rate is determined by the IRS and updated periodically. For expenses incurred on or after January 1, 2005, and before September 1, 2005, the business standard mileage rate specified by the IRS is 40.5 cents per mile. For expenses incurred on or after September 1, 2005, and before January 1, 2006, the business standard mileage rate specified by the IRS is 48.5 cents per mile (IRS Announcement 2005–99 (September 9, 2005)).

The standard mileage rate for charitable purposes is lower than the standard business rate because the charitable rate covers only the out-of-pocket operating expenses (including gasoline and oil) directly related to the use of the automobile in performing the donated services that a taxpayer may deduct as a charitable contribution. The charitable rate does not include costs that are not deductible as a charitable contribution such as general repair or maintenance expenses, depreciation, insurance, and registration fees. Such costs are, however, included in computing the business standard mileage rate.

### *Explanation of Provision*

The provision allows a taxpayer who uses a vehicle in providing donated services to charity solely for the provision of relief related

to Hurricane Katrina to compute the taxpayer's charitable mileage deduction using a rate (rounded to the next highest cent) equal to 70 percent of the business mileage rate in effect on the date of the contribution, rather than the charitable standard mileage rate generally in effect under section 170(i) (14 cents per mile). For purposes of this provision, the term vehicle includes any vehicle described in section 170(f)(12)(E)(i) (i.e., a motor vehicle manufactured primarily for use on the public streets, roads, and highways). As an alternative to determining the amount of the deduction using the mileage rate described in the provision, a taxpayer may determine the amount of the deduction using actual out-of-pocket expenditures.

It is intended that in addition to the present law substantiation requirements for use of the statutory mileage rate, a taxpayer must substantiate that expenses are incurred in providing relief related to Hurricane Katrina. The present-law statutory rate applies if a taxpayer fails to substantiate that the expenses are incurred for the provision of relief related to Hurricane Katrina, assuming all other present-law requirements are met.

The provision applies for purposes of contributions made during the period beginning on August 25, 2005, and ending on December 31, 2006.

### *Effective Date*

The provision is effective on the date of enactment (September 23, 2005).

## D. Mileage Reimbursements to Charitable Volunteers Excluded From Gross Income (sec. 304 of the Act)

### *Present Law*

In general, an itemized deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. Unreimbursed out-of-pocket expenditures made incident to providing donated services to a qualified charitable organization—such as out-of-pocket transportation expenses necessarily incurred in performing donated services—may qualify as a charitable contribution (Treasury Regulation sec. 1.170A–1(g)). No charitable contribution deduction is allowed for traveling expenses (including expenses for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel (sec. 170(j)).

In determining the amount treated as a charitable contribution where a taxpayer operates a vehicle in providing donated services to a charity, the taxpayer either may deduct actual out-of-pocket expenditures or, in the case of a passenger automobile, may use the charitable standard mileage rate. The charitable standard mileage rate is set by statute at 14 cents per mile (sec. 170(i)). The taxpayer may also deduct (under either computation method), any parking fees and tolls incurred in rendering the services, but may not deduct any amount (regardless of the computation method

used) for general repair or maintenance expenses, depreciation, insurance, registration fees, etc. Regardless of the computation method used, the taxpayer must keep reliable written records of expenses incurred. For example, where a taxpayer uses the charitable standard mileage rate to determine a deduction, the IRS has stated that the taxpayer generally must maintain records of miles driven, time, place (or use), and purpose of the mileage. If the charitable standard mileage rate is not used to determine the deduction, the taxpayer generally must maintain reliable written records of actual expenses incurred.

In lieu of actual operating expenses, an optional standard mileage rate may be used in computing the deductible costs of business use of an automobile. The business standard mileage rate is determined by the IRS and updated periodically. For expenses incurred on or after January 1, 2005, and before September 1, 2005, the business standard mileage rate specified by the IRS is 40.5 cents per mile. For expenses incurred on or after September 1, 2005, and before January 1, 2006, the business standard mileage rate specified by the IRS is 48.5 cents per mile (IRS Announcement 2005–99 (September 9, 2005)).

The standard mileage rate for charitable purposes is lower than the standard business rate because the charitable rate covers only the out-of-pocket operating expenses (including gasoline and oil) directly related to the use of the automobile in performing the donated services that a taxpayer may deduct as a charitable contribution. The charitable rate does not include costs that are not deductible as a charitable contribution such as general repair or maintenance expenses, depreciation, insurance, and registration fees. Such costs are, however, included in computing the business standard mileage rate.

Volunteer drivers who are reimbursed for mileage expenses have taxable income to the extent the reimbursement exceeds deductible travel expenses. Employees who are reimbursed for mileage expenses under a qualified arrangement that pays a mileage allowance in lieu of reimbursing actual expenses generally have taxable income to the extent the reimbursement exceeds the amount of the business standard mileage rate multiplied by the actual business miles.

### *Explanation of Provision*

Under the provision, reimbursement by an organization described in section 170(c) (including public charities and private foundations) to a volunteer for the costs of using a passenger automobile in providing donated services to charity solely for the provision of relief related to Hurricane Katrina is excludable from the gross income of the volunteer up to an amount that does not exceed the amount that would be computed using the business standard mileage rate (as periodically adjusted), provided that recordkeeping requirements applicable to deductible business expenses are satisfied. The provision does not permit a volunteer to claim a deduction or credit with respect to amounts excluded under the provision.

The provision applies for purposes of use of a passenger automobile during the period beginning on August 25, 2005, and ending on December 31, 2006.

### *Effective Date*

The provision is effective on the date of enactment (September 23, 2005).

## E. Charitable Deduction for Contributions of Food Inventory (sec. 305 of the Act and sec. 170 of the Code)

### *Present Law*

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis (sec. 170(e)(3)). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income (sec. 170(b)(2)). To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory (Treas. Reg. sec. 1.170A–4A(c)(3)). Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

### *Explanation of Provision*[254]

Under the provision, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for donations of food inventory. For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other entity that is

[254] The provision was subsequently extended in section 1202 of the Pension Protection Act of 2006, Pub. L. No. 109–280, described in Part Thirteen.

not a C corporation) from which contributions of apparently wholesome food are made. For example, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the taxpayer's interest in the S corporation, but not the taxpayer's interest in the partnership.

Under the provision, the enhanced deduction is available only for food that qualifies as "apparently wholesome food." "Apparently wholesome food" is defined as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

The provision does not apply to contributions made after December 31, 2005.

### *Effective Date*

The provision is effective for contributions made on or after August 28, 2005, in taxable years ending after such date.

## F. Charitable Deduction for Contributions of Book Inventories to Public Schools (sec. 306 of the Act and sec. 170 of the Code)

### *Present Law*

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis (sec. 170(e)(3)). To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must: (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inven-

tory (Treas. Reg. sec. 1.170A–4A(c)(3)). Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

### *Explanation of Provision*[255]

The provision extends the present-law enhanced deduction for C corporations to qualified book contributions. A qualified book contribution means a charitable contribution of books to a public school that provides elementary education or secondary education (kindergarten through grade 12) and that is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The enhanced deduction is not allowed unless the donee organization certifies in writing that the contributed books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs.

The provision does not apply to contributions made after December 31, 2005.

### *Effective Date*

The provision is effective for contributions made on or after August 28, 2005, in taxable years ending after such date.

[255] The provision was subsequently extended in section 1204 of the Pension Protection Act of 2006, Pub. L. No. 109–280, described in Part Thirteen.

## TITLE IV—ADDITIONAL TAX RELIEF PROVISIONS

### A. Exclusion for Certain Cancellations of Indebtedness by Reason of Hurricane Katrina (sec. 401 of the Act)

#### *Present Law*

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain farm indebtedness, and certain real property business indebtedness (secs. 61(a)(12) and 108). In cases involving discharges of indebtedness that are excluded from gross income (except for discharges of real property business indebtedness), taxpayers generally exclude discharge of indebtedness from income but reduce tax attributes by the amount of the discharge of indebtedness. The amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt- for-debt exchange).

Present law generally requires "applicable entities" to file information returns with the IRS regarding any discharge of indebtedness in the amount of $600 or more (sec. 6050P). This requirement applies without regard to whether the debtor is subject to tax on the discharged indebtedness. The term "applicable entities" (as defined in sec. 6050P(c)(1) includes: (1) any financial institution (as described in section 581 (relating to banks) or section 591(a) (relating to savings institutions)); (2) any credit union; (3) any corporation that is a direct or indirect subsidiary of an entity described in (1) or (2) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a Federal or State agency regulating such entities; (4) the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, the National Credit Union Administration, certain other Federal executive agencies, and any successor or subunit of any of them; (5) an executive, judicial, or legislative agency (as defined in 31 U.S.C. section 3701(a)(4)); and (6) any other organization a significant trade or business of which is the lending of money. Failures to file correct information returns with the IRS or to furnish statements to taxpayers with respect to these discharges of indebtedness are subject to the same general penalty that is imposed with respect to failures to provide other types of information returns. Accordingly, the penalty for failure to furnish statements to taxpayers generally is $50

per failure, subject to a maximum of $100,000 for any calendar year. These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

### *Explanation of Provision*

The provision provides that gross income of a qualified individual does not include any amount which would otherwise be includible in gross income by reason of a discharge (in whole or in part) of nonbusiness debt if the indebtedness is discharged by an applicable entity. For these purposes, nonbusiness debt is any indebtedness other than indebtedness incurred in connection with a trade or business. The discharge of indebtedness relief allowed under this provision does not apply to any indebtedness to the extent that real property constituting security for such indebtedness is located outside the Hurricane Katrina disaster area. As under the present-law rules, the amount excluded from gross income under this provision reduces the tax attributes of the taxpayer.

A qualified individual is any natural person if the principal place of abode of such person on August 25, 2005 was located: (1) in the core disaster area; or (2) in the Hurricane Katrina disaster area and such person suffered economic loss by reason of Hurricane Katrina. An applicable entity is defined as under present-law section 6050P(c)(1).

The provision does not apply to discharges made after December 31, 2006.

### *Effective Date*

The provision applies to discharges made on or after August 25, 2005.

## B. Suspension of Certain Limitations on Personal Casualty Losses (sec. 402 of the Act)

### *Present Law*

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.

### *Explanation of Provision*

The provision removes two limitations on personal casualty or theft losses to the extent those losses arise in the Hurricane Katrina disaster area on or after August 25, 2005, and are attributable to Hurricane Katrina. First, personal casualty or theft losses meeting the above requirements need not exceed $100 per casualty or theft. Second, such losses are deductible without regard to whether aggregate net losses exceed 10 percent of a taxpayer's ad-

justed gross income. For purposes of applying the 10 percent threshold to other personal casualty or theft losses, losses deductible under this provision are disregarded. Thus, the provision has the effect of treating personal casualty or theft losses from Hurricane Katrina as a deduction separate from all other casualty losses.

### *Effective Date*

The provision is effective for losses arising on or after August 25, 2005.

## C. Required Exercise of IRS Administrative Authority (sec. 403 of the Act)

### *Present*

#### *General time limits for filing tax returns*

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

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

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

#### *Suspension of time periods*

In general, the period of time for performing various acts under the Code, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, is suspended for any individual serving in the Armed Forces of the United States in an area designated as a "combat zone" or when deployed outside the United States away from the individual's permanent duty station while participating in an operation designated by the Secretary of Defense as a "contingency operation" or that becomes a contingency operation. The suspension of time also applies to an individual serving in support of such Armed Forces in the combat zone or contingency operation, such as Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those Forces. The designation of a combat zone must be made by the President in an Executive Order. A contingency operation is defined as a military operation that is designated by the Secretary of Defense as an operation in which members of the

Armed Forces are or may become involved in military actions, operations, or hostilities against an enemy of the United States or against an opposing military force, or results in the call or order to (or retention of) active duty of members of the uniformed services during a war or a national emergency declared by the President or Congress.

The suspension of time encompasses the period of service in the combat zone during the period of combatant activities in the zone or while participating in a contingency operation, as well as (1) any time of continuous qualified hospitalization resulting from injury received in the combat zone or contingency operation or (2) time in missing in action status, plus the next 180 days.

The suspension of time applies to the following acts:

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

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

### *Explanation of Provision*

The provision clarifies the scope of the Secretary's authority to suspend the time period for certain acts. The provision also adds employment and excise taxes to those items for which the Secretary may suspend filing and payment requirements for taxpayers serving in combat zones or contingency operations, as well as taxpayers affected by Presidentially declared disasters or terroristic or military actions.

In the case of taxpayers determined to be affected by the Presidentially declared disaster relating to Hurricane Katrina, any administrative relief from required acts, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, shall be for a period ending not earlier than February 28, 2006. The provision also clarifies that any administrative relief provided to tax-

payers affected by Hurricane Katrina prior to the date of enactment shall be treated as applying to the filing of returns relating to, and the payment of, employment and excise taxes.

### *Effective Date*

The provision extending IRS administrative relief relating to Hurricane Katrina until at least February 28, 2006, is effective on the date of enactment (September 23, 2005). The amendments adding employment and excise taxes to those items for which the Secretary may suspend filing and payment requirements are effective for any period for performing an act which has not expired before August 25, 2005.

## D. Special Rules for Mortgage Revenue Bonds (sec. 404 of the Act)

### *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 which 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 homebuyers and purchase price limitations for the home financed with bond proceeds. 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). The first-time homebuyer requirement does not 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.

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

or energy efficiency of the property. Under present law, qualified home-improvement loans may not exceed $15,000.

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.

### *Explanation of Provision*[256]

The provision waives the first-time homebuyer requirement for qualified Hurricane Katrina recovery residences by treating such residences as if they were targeted area residences. A qualified Hurricane Katrina recovery residence is defined as (1) any residence located in the core disaster area and (2) any other residence if, on August 28, 2005, the mortgagor of such residence owned a principal residence in the Hurricane Katrina disaster area that was rendered uninhabitable by reason of Hurricane Katrina and the residence being financed is located in the same State as the prior principal residence. The provision applies to residences financed before January 1, 2008.

The provision also increases from $15,000 to $150,000 the permitted amount of a qualified home-improvement loan 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.

### *Effective Date*

The provision is effective on the date of enactment (September 23, 2005).

## E. Extension of Replacement Period for Nonrecognition of Gain (sec. 405 of the Act)

### *Present Law*

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

Under section 1033, gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within the applicable period. The taxpayer's basis in the replacement property generally is the cost of such property, reduced by the amount of gain not recognized.

The applicable period for the taxpayer to replace the converted property begins with the date of the disposition of the converted property (or if earlier, the earliest date of the threat or imminence

[256] The provision was subsequently extended in section 104 of the Gulf Opportunity Zone Act of 2005, Pub. L. No. 109–135, described in Part Nine.

of requisition or condemnation of the converted property) and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized (the "replacement period").

Special rules extend the replacement period for certain real property and principal residences damaged by a Presidentially declared disaster to three years and four years, respectively, after the close of the first taxable year in which gain is realized. Similarly, the replacement period for livestock sold on account of drought, flood, or other weather-related conditions is extended from two years to four years after the close of the first taxable year in which any part of the gain on conversion is realized. In the case of property compulsorily or involuntarily converted as a result of the terrorist attacks on September 11, 2001, in the New York Liberty Zone, the replacement period is extended from two years to five years, but only if substantially all of the use of the replacement property is in the city of New York (sec. 1400L(g)).

### *Explanation of Provision*

The provision extends from two to five years the replacement period in which a taxpayer may replace converted property, in the case of property that is in the Hurricane Katrina disaster area and that is compulsorily or involuntarily converted on or after August 25, 2005, by reason of Hurricane Katrina. Substantially all of the use of the replacement property must be in this area.

### *Effective Date*

The provision is effective on the date of enactment (September 23, 2005).

## F. Special Look-Back Rule for Determining Earned Income Credit and Refundable Child Credit (sec. 406 of the Act)

### *Present Law*

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).

### *Explanation of Provision*

The provision permits qualified individuals to 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. 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. Qualified individuals are (1) individuals who on August 25, 2005, had their principal place of abode in the 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 the provision, in the case of a joint return for a taxable year which includes August 25, 2005, the provision applies if either spouse is a qualified individual. In such cases, the earned income which is attributable to the taxpayer for the preceding taxable year is the sum of the earned income which is attributable to each spouse for such preceding taxable year.

Any election to use the prior year's earned income under the provision 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 an election under this provision is treated as a mathematical or clerical error. An election under the provision is disregarded for purposes of calculating gross income in the election year.

### *Effective Date*

The provision is effective for the taxable year of a qualified individual that includes August 25, 2005.

## G. Secretarial Authority to Make Adjustments Regarding Taxpayer and Dependency Status for Taxpayers Affected by Hurricane Katrina (sec. 407 of the Act)

### *Present Law*

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).

### *Explanation of Provision*

The provision authorizes the Secretary 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 under this provision must insure that an individual is not taken into account by more than one taxpayer with respect to the same tax benefit.

The provision applies only for taxable years beginning in 2005 or 2006.

### *Effective Date*

The provision is effective on the date of enactment (September 23, 2005).

## PART EIGHT: SPORTFISHING AND RECREATIONAL BOATING SAFETY AMENDMENTS ACT OF 2005 (PUBLIC LAW 109–74)[257]

### A. Sportfishing and Recreational Boating Safety Amendments Act of 2005 (secs. 101 and 301 of the Act and sec. 9504 of the Code)

#### *Present Law*

Prior to October 1, 2005, the effective date of the Sportfishing and Recreational Boating Safety Act of 2005 (the "Sportfishing Act"),[258] section 9504(c) provided that amounts in the Boat Safety Account of the Aquatic Resources Trust Fund would be available for making expenditures before August 15, 2005, to carry out the purposes of the applicable expenditure provisions.[259] The Sportfishing Act eliminated the Aquatic Resources Trust Fund and future transfers to the Boat Safety Account and transformed the Sport Fish Restoration Account of the Aquatic Resources Trust Fund into the Sport Fish Restoration and Boating Trust Fund. Under the Sportfishing Act, existing amounts in the Boat Safety Account, plus interest accrued on interest-bearing obligations of such account, are made available after September 30, 2005 as provided under expenditure provisions.[260] The expenditure provisions also authorize the appropriation of amounts into the Sport Fish Restoration and Boating Trust Fund for the uses authorized in the expenditure provisions, including for boating safety. However, the Sportfishing Act does not provide that amounts in the Boat Safety Account would be available for making expenditures after August 14, 2005 and before October 1, 2005.

#### *Explanation of Provision*

Except for specific expenditures stated in the Act, the provision temporarily preserves the provisions of law existing prior to the enactment of the Sportfishing Act,[261] during the period from the date of enactment of the Sportfishing Act through September 30, 2005.

---

[257] H.R. 3649. The House passed the bill on the suspension calendar on September 13, 2005. The Senate passed the bill by unanimous consent on September 15, 2005. The President signed the bill on September 29, 2005.

[258] Pub. L. No. 109–59, secs. 10101–10143, enacted August 10, 2005.

[259] Expenditures from the Boat Safety Account are subject to annual appropriations.

[260] The expenditure provisions are codified at 16 U.S.C. sec. 777 et seq., as amended by the Sportfishing and Recreational Boating Safety Act of 2005.

[261] These rules are generally found in the Act of August 9, 1950, 64 Stat. 430 (codified at 16 U.S.C. sec. 777 et seq.) ("An Act to provide that the United States shall aid the States in fish restoration and management projects, and for other purposes," commonly referred to as the Dingell-Johnson Sport Fish Restoration Act.).

***Effective Date***

The provisions are effective on the date of enactment (September 29, 2005).

# PART NINE: GULF OPPORTUNITY ZONE ACT OF 2005 (PUBLIC LAW 109–135)[262]

## TITLE I—ESTABLISHMENT OF GULF OPPORTUNITY ZONE

### A. Tax Benefits for Gulf Opportunity Zone

### 1. Definitions of "Gulf Opportunity Zone," "Rita GO Zone," "Wilma GO Zone," and other definitions (sec. 101 of the Act and new sec. 1400M of the Code)

#### *General Definitions*

***Gulf Opportunity Zone***

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

***Hurricane Katrina disaster area***

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

***Rita GO Zone***

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

***Hurricane Rita disaster area***

The term "Hurricane Rita disaster area" means an area with respect to which a major disaster has been declared by the President before October 6, 2005, under section 401 of the Robert T. Stafford

[262] H.R. 4440. The House passed the bill on the suspension calendar on December 7, 2005. The Senate passed the bill with an amendment by unanimous consent on December 16, 2005. The House agreed to the Senate amendment without objection on December 16, 2005. The President signed the bill on December 22, 2005. For a technical explanation of the bill prepared by the staff of the Joint Committee on Taxation, see Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of H.R. 4440, the "Gulf Opportunity Zone Act of 2005" as Passed by the House of Representatives and the Senate* (JCX–88–05), December 16, 2005. For references to the technical explanation, see 151 Cong. Rec. H 11940 (December 16, 2005) and 151 Cong. Rec. S 14028 (December 19, 2005).

Disaster Relief and Emergency Assistance Act, by reason of Hurricane Rita.

***Wilma GO Zone***

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

***Hurricane Wilma disaster area***

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

**2. Tax-exempt bond financing for the Gulf Opportunity Zone (sec. 101 of the Act and new sec. 1400N(a) of the Code)**

***Present Law***

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

*In general*

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

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

The definition of qualified private activity bonds includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond (sec. 141(e)). The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); qualified residential rental projects; privately owned and/or operated utility facilities (sewage, water, solid waste disposal, and local district heating and cooling facilities, certain private electric and gas facilities, and hydroelectric dam enhancements); public/private educational facilities; qualified green building and sustainable design projects; and qualified highway or surface freight transfer facilities (sec. 142(a)).

As noted above, subject to certain requirements, qualified private activity bonds may be issued to finance residential rental property or owner-occupied housing. Residential rental property may be financed with exempt facility bonds if the financed project is a "qualified residential rental project." A project is a qualified resi-

dential rental project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the "20–50 test"). Alternatively, a project is a qualified residential rental project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the "40–60 test").

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

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

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

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

bonds, and qualified highway or surface freight transfer facility bonds).

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

Moreover, the term of qualified private activity bonds generally may not exceed 120 percent of the economic life of the property being financed and certain public approval requirements (similar to requirements that typically apply under State law to issuance of governmental debt) apply under Federal law to issuance of private activity bonds.

*Liberty Zone Bonds*

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

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

*Arbitrage restrictions on tax-exempt bonds*

To prevent States and local governments from issuing more tax-exempt bonds than necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. In general, arbitrage profits may be earned only during specified peri-

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

### *Explanation of Provision*

#### *Gulf Opportunity Zone Bonds*

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

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

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

Bond proceeds may not be used to finance movable fixtures and equipment. The purpose of this limitation is to ensure that property financed with the bonds will remain in the Gulf Opportunity Zone. "Movable fixtures and equipment" does not include components that are assembled to construct an industrial plant. Such

term also does not include consumer appliances installed in owner-occupied residences and residential rental property financed with the proceeds of Gulf Opportunity Zone Bonds.

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

Gulf Opportunity Zone Bonds are treated as qualified mortgage bonds if the bonds of such issue meet the requirements of a qualified mortgage issue (as defined in section 143 and modified by this provision) and the residences financed with such bonds are located in the Gulf Opportunity Zone. For these purposes, residences located in the Gulf Opportunity Zone are treated as targeted area residences. Thus, the first-time homebuyer rule is waived and purchase and income rules for targeted area residences apply to residences financed with bonds issued under the provision. Under the provision, 100 percent of the mortgages must be made to mortgagors whose family income is 140 percent or less of the applicable median family income. Thus, the present law rule allowing one-third of the mortgages to be made without regard to any income limits does not apply. In addition, the provision increases from $15,000 to $150,000 the amount of a qualified home-improvement loan that may be financed with bond proceeds.

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

(1) Except as otherwise permitted for a qualified mortgage issue, repayments of bond-financed loans may not be used to make additional loans;

(2) Issuance of the bonds is not subject to the aggregate annual State private activity bond volume limits (sec. 146);

(3) The restriction on acquisition of existing property is applied using a minimum requirement of 50 percent of the cost of acquiring the building being devoted to rehabilitation (sec. 147(d));

(4) The special arbitrage expenditure rules for certain construction bond proceeds apply to available construction proceeds of Gulf Opportunity Zone Bonds issued to finance qualified project costs, treating such bonds as a construction issue (sec. 148(f)(4)(C));

(5) Interest on the bonds is not a preference item for purposes of the alternative minimum tax preference for private activity bond interest (sec. 57(a)(5)); and

(6) No portion of the proceeds of the bonds may be used to provide any property described in section 144(c)(6)(B) (i.e., any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal purpose of which is the sale alcoholic beverages for consumption off premises).

### *Effective Date*

The provision is effective for bonds issued after the date of enactment (December 22, 2005).

## 3. Advance refunding of certain tax-exempt bonds (sec. 101 of the Act and new sec. 1400N(b) of the Code)

### *Present Law*

#### *In general*

Interest on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units ("governmental bonds"). Interest on State or local bonds to finance activities of private persons ("private activity bonds") is taxable unless a specific exception applies. Bonds issued to finance the activities of charitable organizations described in section 501(c)(3) ("qualified 501(c)(3) bonds") are one type of tax-exempt private activity bonds ("qualified private activity bonds"). Qualified private activity bonds also include exempt facility bonds. The definition of exempt facility bonds includes bonds issued to finance certain transportation facilities (e.g., airports, docks, and wharves).

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

#### *Limitations on advance refundings*

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

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

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

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

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

## *Explanation of Provision*

The provision permits an additional advance refunding of certain governmental and qualified 501(c)(3) bonds issued by the State of Alabama, Louisiana, or Mississippi, or any political subdivision thereof. The provision also permits one advance refunding of certain exempt facility bonds for airports, docks, or wharves issued by the State of Alabama, Louisiana, or Mississippi, or any political subdivision thereof, notwithstanding the general prohibition on the advance refunding of such bonds. The provision is effective for advance refunding bonds issued after the date of enactment and before January 1, 2011.

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

refunded bond. Thus, at no time after the advance refunding authorized under the provision occurs may there be more than two bond issues outstanding.

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

### *Effective Date*

The provision is effective for advance refunding bonds issued after the date of enactment (December 22, 2005).

## 4. Increase the low-income housing credit cap and make other modifications (sec. 101 of the Act and new sec. 1400N(c) of the Code)

### *Present Law*

#### *In general*

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

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

#### *Income targeting*

In order to be eligible for the low-income housing credit, a qualified low-income building must be part of a qualified low-income housing project. In general, a qualified low-income housing project is defined as a project which satisfies one of two tests at the election of the taxpayer. The first test is met if 20 percent or more of

the residential units in the project are both rent-restricted and occupied by individuals whose income is 50 percent or less of area median gross income (the "20–50 test"). The second test is met if 40 percent or more of the residential units in such project are both rent-restricted and occupied by individuals whose income is 60 percent or less of area median gross income (the "40–60 test").

***Credit cap***

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

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

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

***Stacking rule***

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

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

The national pool consists of States' unused housing credit carryovers. For each State, the unused housing credit carryover for a calendar year consists of the excess (if any) of the unused State housing credit ceiling for such year over the excess (if any) of the aggregate housing credit dollar amount allocated for such year over the sum of $1.90 per resident and the credit returns for such year. The amounts in the national pool are allocated only to States that allocated their entire housing credit ceiling for the preceding cal-

endar year and requested a share in the national pool not later than May 1 of the calendar year. The national pool allocation to qualified States is made on a pro rata basis equivalent to the fraction that a State's population enjoys relative to the total population of all qualified States for that year.

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

### *Explanation of Provision*

#### *Income targeting*

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

#### *Credit cap*

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

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

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

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

its credit allocation under the otherwise applicable low-income housing credit cap or the additional credit cap.

***Carryover***

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

***Stacking rule***

Within each calendar year (2006, 2007, and 2008), each applicable State within the GO Zone must treat the additional credit cap allocable under the provision to that State as allocated before any other credit cap amounts. Therefore, under the provision each applicable State within the GO Zone is treated as using credits in the following order: (1) the additional credit cap (including any such credits returned to the State) under the Gulf Opportunity Zone, then (2) its allocation of the unused State housing credit ceiling (if any) from the preceding calendar, then (3) the current year's allocation of present-law credit (including any credits returned to the State) and then (4) any national pool allocations. This generally maximizes the total amount of credit (under both otherwise applicable low income housing credit cap and the additional credit cap for the Gulf Opportunity Zone) which may be carried forward.

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

### *Effective Date*

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

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

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

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

### 5. Additional first-year depreciation for Gulf Opportunity Zone property (sec. 101 of the Act and new sec. 1400N(d) of the Code)

#### *Present Law*

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

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

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

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment generally may elect to deduct the cost of qualifying property placed in service for the taxable year. (Sec. 179). In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

#### *Explanation of Provision*[263]

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

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

[263] The provision was subsequently extended with respect to specified Gulf Opportunity Zone extension property in section 120 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

ternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

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

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

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

### *Effective Date*

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

## 6. Increase in expensing for Gulf Opportunity Zone property (sec. 101 of the Act and new sec. 1400N(e) of the Code)

### *Present Law*

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

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

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

An expensing election is made under rules prescribed by the Secretary (sec. 179(c)(1)). Under Treas. Reg. sec. 179–5, applicable to property placed in service in taxable years beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. For taxable years beginning in 2008 and thereafter, an expensing election may be revoked only with consent of the Commissioner (sec. 179(c)(2)).

### *Explanation of Provision*

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

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

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

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

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

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

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

### *Effective Date*

The provision is effective for taxable years ending on or after August 28, 2005, for qualified section 179 Gulf Opportunity Zone property acquired after August 27, 2005.

## 7. Expensing for certain demolition and clean-up costs (sec. 101 of the Act and new sec. 1400N(f) of the Code)

### *Present Law*

Under present law, the cost of demolition of a structure is capitalized into the taxpayer's basis in the land on which the structure

is located. (Sec. 280B). Land is not subject to an allowance for depreciation or amortization.

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

### *Explanation of Provision*

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

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

### *Effective Date*

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

## 8. Extension and expansion of expensing for environmental remediation costs (sec. 101 of the Act and new sec. 1400N(g) of the Code)

### *Present Law*

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

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

Section 198(d)(1) defines a "hazardous substance" as a substance which is so defined in section 101(14) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA"), and any substance which is administratively des-

ignated as a hazardous substance under section 102 of CERCLA. Under section 198(d)(2), however, the term "hazardous substance" does not include any substance with respect to which a removal or remediation is not permitted under section 104 of CERCLA by reason of subsection (a)(3) thereof, which exempts from the scope of such provision "the release or threat of release (A) of a naturally occurring substance in its unaltered form, or altered solely through naturally occurring processes or phenomena, from a location where it is naturally found; (B) from products which are part of the structure of, and result in exposure within, residential buildings or business or community structures; or (C) into public or private drinking water supplies due to deterioration of the system through ordinary use." However, sites which are identified on the national priorities list under CERCLA cannot qualify for expensing under section 198.

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

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

### *Explanation of Provision*

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

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

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

### *Effective Date*

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

### 9. Increase in rehabilitation tax credit with respect to certain buildings located in the Gulf Opportunity Zone (sec. 101 of the Act and new sec. 1400N(h) of the Code)

#### *Present Law*

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

A 20-percent credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

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

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

#### *Explanation of Provision*

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

#### *Effective Date*

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

### 10. Increased expensing for reforestation expenditures of small timber producers (sec. 101 of the Act and new sec. 1400N(i)(1) of the Code)

#### *Present Law*

Present law permits a taxpayer to elect to deduct (or "expense") a limited amount of certain reforestation expenditures that would otherwise be required to be capitalized, in the year paid or incurred (sec. 194(b)). No more than $10,000 of reforestation expenditures

made by a taxpayer in any year can qualify for expensing with respect to each qualified timber property. The limit is reduced to $5,000 per qualified timber property for married taxpayers filing separate returns.

All members of a controlled group of corporations are treated as a single taxpayer for purposes of the $10,000 limit. A controlled group of corporations for purposes of section 194 is defined as under section 1563(a), except that the 80-percent ownership requirement is reduced to a more than 50-percent requirement. If a partnership or S corporation incurs reforestation expenditures, the $10,000 limit applies separately to the partnership or S corporation and to each partner or shareholder. For an estate with reforestation expenditures, the $10,000 limit is apportioned between the estate and its beneficiaries. Section 194(b) does not apply to trusts.

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

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

### *Explanation of Provision*

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

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

The provision applies to taxpayers with aggregate holdings of qualified timber property which do not exceed 500 acres at any time during the taxable year. "Qualified timber property" is defined by section 194(c)(1) as "a woodlot or other site located in the United States which will contain trees in significant commercial quantities and which is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products."

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

### *Effective Date*

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

## 11. Five-year NOL carryback of certain timber losses (sec. 101 of the Act and new sec. 1400N(i)(2) of the Code)

### *Present Law*

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

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

A farming loss cannot exceed the taxpayer's NOL for the taxable year. In calculating the amount of a taxpayer's NOL carrybacks, the portion of the NOL that is attributable to a farming loss is

treated as a separate NOL and is taken into account after the remaining portion of the NOL for the taxable year.

### *Explanation of Provision*

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

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

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

### *Effective Date*

The provision 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 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).

## 12. Special rule for Gulf Opportunity Zone public utility casualty losses (sec. 101 of the Act and new sec. 1400N(j) of the Code)

### *Present Law*

#### *In general*

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

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

#### *Exceptions to the general rule*

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

#### *Specified liability losses*

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

### *Explanation of Provision*

The provision provides an election for taxpayers to treat any Gulf Opportunity Zone public utility casualty loss as a specified liability loss to which the present-law 10-year carryback period applies. A Gulf Opportunity Zone public utility casualty loss is any casualty loss of public utility property by reason of Hurricane Katrina which is allowed as a deduction under section 165. The amount of the casualty loss is reduced by the amount of any gain recognized by the taxpayer from involuntary conversions of public utility property located in the Gulf Opportunity Zone caused by Hurricane Katrina. The total amount of specified liability loss, including any amount of public utility casualty loss treated as such, is limited to the amount of the taxpayer's overall NOL for the taxable year as under present law. Taxpayers who elect the applicability of the proposed provision with respect to any loss are not eligible to also treat the

loss as having occurred in any prior taxable year under section 165(i), nor may they include the casualty loss as part of the five-year NOL carryback provided under another provision of the Act.

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

### *Effective Date*

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

## 13. Five-year NOL carryback for certain amounts related to Hurricane Katrina or the Gulf Opportunity Zone (sec. 101 of the Act and new sec. 1400N(k) of the Code)

### *Present Law*

#### *In general*

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

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

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

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

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

carryforwards to these taxable years, offset 100 percent of a taxpayer's AMTI.

### *Explanation of Provision*

#### *In general*

The provision provides a special five-year carryback period for NOLs to the extent of certain specified amounts related to Hurricane Katrina or the Gulf Opportunity Zone. The amount of the NOL which is eligible for the five year carryback ("eligible NOL") is limited to the aggregate amount of the following deductions: (i) qualified Gulf Opportunity Zone casualty losses; (ii) certain moving expenses; (iii) certain temporary housing expenses; (iv) depreciation deductions with respect to qualified Gulf Opportunity Zone property for the taxable year the property is placed in service; and (v) deductions for certain repair expenses resulting from Hurricane Katrina. The provision applies for losses paid or incurred after August 27, 2005, and before January 1, 2008; however, an irrevocable election not to apply the five-year carryback under the provision may be made with respect to any taxable year.

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

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

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

#### *Moving expenses*

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

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

***Temporary housing expenses***

Any deduction for expenses of an employer to temporarily house employees who are employed in the Gulf Opportunity Zone may be included in the eligible NOL. It is not necessary for the temporary housing to be located in the Gulf Opportunity Zone in order for such expenses to be included in the eligible NOL; however, the employee's principal place of employment with the taxpayer must be in Gulf Opportunity Zone. So, for example, if a taxpayer temporarily houses an employee at a location outside of the Gulf Opportunity Zone, and the employee commutes into the Gulf Opportunity Zone to the employee's principal place of employment, such temporary housing costs will be included in the eligible NOL (assuming all other requirements are met).

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

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

***Repair expenses***

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

***Other rules***

The amount of the NOL to which the five-year carryback period applies is limited to the amount of the corporation's overall NOL

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

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

### *Effective Date*

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

## 14. Gulf tax credit bonds (sec. 101 of the Act and new sec. 1400N(l) of the Code)

### *Present Law*

#### *In general*

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

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

#### *Tax-credit bonds*

As an alternative to traditional tax-exempt bonds, States and local governments may issue tax-credit bonds for limited purposes. Rather than receiving interest payments, a taxpayer holding a tax-credit bond on an allowance date is entitled to a credit. Generally, the credit amount is includible in gross income (as if it were a taxable interest payment on the bond), and the credit may be claimed

against regular income tax and alternative minimum tax liability. Two types of tax-credit bonds may be issued under present law, "qualified zone academy bonds," which are bonds issued for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other personnel at certain school facilities, and "clean renewable energy bonds," which are bonds issued to finance facilities that would qualify for the tax credit under section 45 without regard to the placed in service date requirements of that section.

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

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

## *Explanation of Provision*

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

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

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

### *Effective Date*

The provision is effective for bonds issued after December 31, 2005.

## 15. Additional allocation of new markets tax credit for investments that serve the Gulf Opportunity Zone (sec. 101 of the Act and new sec. 1400N(m) of the Code)

### *Present Law*

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

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE. A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder. Substantially all of the investment proceeds must

be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.

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

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

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

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

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective on the date of enactment (December 22, 2005).

## 16. Representations regarding income eligibility for purposes of qualified residential rental project requirements (sec. 101 of the Act and new sec. 1400N(n) of the Code)

### *Present Law*

#### *In general*

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

#### *Qualified private activity bonds*

The definition of a qualified private activity bond includes an exempt facility bond, or qualified mortgage, veterans' mortgage, small issue, redevelopment, 501(c)(3), or student loan bond. The definition of exempt facility bond includes bonds issued to finance certain transportation facilities (airports, ports, mass commuting, and high-speed intercity rail facilities); qualified residential rental projects; privately owned and/or operated utility facilities (sewage, water, solid waste disposal, and local district heating and cooling facilities, certain private electric and gas facilities, and hydroelectric dam enhancements); public/private educational facilities; qualified green building and sustainable design projects; and qualified highway or surface freight transfer facilities.

Subject to certain requirements, qualified private activity bonds may be issued to finance residential rental property or owner-occu-

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

### *Explanation of Provision*

Under the provision, the operator of a qualified residential rental project may rely on the representations of prospective tenants displaced by reason of Hurricane Katrina for purposes of determining whether such individual satisfies the income limitations for qualified residential rental projects and, thus, the project is in compliance with the 20–50 test or the 40–60 test. (For a description of modifications to the 20–50 test and the 40–60 test for qualified residential rental projects financed in the GO Zone, see I.A.2. Tax-exempt financing for the Gulf Opportunity Zone, above).

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

### *Effective Date*

The provision is effective on the date of enactment (December 22, 2005).

## 17. Treatment of public utility property disaster losses (sec. 101 of the Act and new sec. 1400N(o) of the Code)

### *Present Law*

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

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

### *Explanation of Provision*

The provision provides an election for taxpayers who incurred casualty losses attributable to Hurricane Katrina with respect to public utility property located in the Gulf Opportunity Zone. Under the election, such losses may be taken into account in the fifth taxable year (rather than the 1st taxable year) immediately preceding the taxable year in which the loss occurred. If the application of

this provision results in the creation or increase of a net operating loss for the year in which the casualty loss is taken into account, the net operating loss may be carried back or carried over as under present law applicable to net operating losses for such year.

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

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

### *Effective Date*

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

## 18. Tax benefits not available with respect to certain property (sec. 101 of the Act and new sec. 1400N of the Code)

### *Present Law*

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

### *Explanation of Provision*

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

beverages for consumption off premises. The provisions also do not apply with respect to any gambling or animal racing property.

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

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

### *Effective Date*

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

## 19. Expansion of Hope Scholarship and Lifetime Learning Credit for students in the Gulf Opportunity Zone (sec. 102 of the Act and new sec. 1400O of the Code)

### *Present Law*

#### *Hope credit*

The Hope credit (sec. 25A) is a nonrefundable credit of up to $1,500 per student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program. The Hope credit rate is 100 percent on the first $1,000 of qualified tuition and related expenses, and 50 percent on the next $1,000 of qualified tuition and related expenses. The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between $43,000 and $53,000 ($87,000 and $107,000 for married taxpayers filing a joint return) for 2005. These adjusted gross income phase-out ranges are indexed for inflation. Also, each of the $1,000 amounts of qualified tuition and related expenses to which the 100-percent credit rate and 50 per-

cent credit rate apply are indexed for inflation, with the amount rounded down to the next lowest multiple of $100. The first adjustment to these qualified expense amounts as a result of inflation is expected in 2006. The Hope credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2006.

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

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

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

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

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

Effective for taxable years beginning after December 31, 2010, the changes to the Hope credit made by EGTRRA no longer apply. The EGTRRA change scheduled to expire is the change that permitted a taxpayer to claim a Hope credit in the same year that he

or she claimed an exclusion from an education savings account. Thus, after 2010, a taxpayer cannot claim a Hope credit in the same year he or she claims an exclusion from an education savings account.

***Lifetime Learning credit***

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

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

A taxpayer may claim the Lifetime Learning credit for a taxable year with respect to one or more students, even though the taxpayer also claims a Hope credit for that same taxable year with respect to other students. If, for a taxable year, a taxpayer claims a Hope credit with respect to a student, then the Lifetime Learning credit is not available with respect to that same student for that year (although the Lifetime Learning credit may be available with respect to that same student for other taxable years). As with the Hope credit, a taxpayer may not claim the Lifetime Learning credit and also claim the section 222 deduction for qualified tuition and related expenses (described below).

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

dent's degree program, or the education is undertaken to acquire or improve the job skills of the student.

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

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

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

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

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

Present law provides favorable tax treatment for qualified tuition programs that meet the requirements of section 529 of the Code. For purposes of the rules relating to qualified tuition programs, "qualified higher education expenses" means tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution and expenses for special needs services in the case of a special needs beneficiary which are incurred in connection with such enrollment or attendance. In addition, in the case of at least half-time students, qualified higher education expenses include certain room and board expenses.

## *Explanation of Provision*

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

Under the provision, the Hope credit is increased to 100 percent of the first $2,000 in qualified tuition and related expenses and 50 percent of the next $2,000 of qualified tuition and related expenses

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

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

### *Effective Date*

The provision is effective on the date of enactment (December 22, 2005).

## 20. Housing relief for individuals affected by Hurricane Katrina (sec. 103 of the Act and new sec. 1400P of the Code)

### *Present Law*

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

### *Explanation of Provision*

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

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

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

### *Effective Date*

The provision applies to lodging provided during the period beginning on the first day of the first month beginning after the date of enactment (December 22, 2005) and ending on the date that is six months after such first day.

## 21. Special rules for mortgage revenue bonds (sec. 104 of the Act and sec. 404 of the Katrina Emergency Tax Relief Act of 2005)

### *Present Law*

#### *In general*

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

#### *Qualified mortgage bonds*

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

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

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

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

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

### *Explanation of Provision*

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

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

### *Effective Date*

The provision is effective on the date of enactment (December 22, 2005).

## 22. Treasury authority to grant bonus depreciation placed-in-service date relief (sec. 105 of the Act and sec. 168(k) of the Code)

### *Present Law*

#### *In general*

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property

range from three to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

***Additional first year depreciation deduction***

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

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

The applicable time period for acquired property is (1) after September 10, 2001 and before January 1, 2005, but only if no binding written contract for the acquisition is in effect before September 11, 2001, or (2) pursuant to a binding written contract which was entered into after September 10, 2001, and before January 1, 2005. With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after September 10, 2001. For property eligible for the extended placed-in-service date, a special rule limits the amount of costs eligible for the additional first year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2005 ("progress expenditures") is eligible for the additional first-year depreciation. For purposes of determining the amount of eligible progress expenditures, rules similar to sec. 46(d)(3) as in effect prior to the Tax Reform Act of 1986 apply.

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

1. be acquired by the taxpayer during the applicable time period as under present law;

2. meet the appropriate placed-in-service date requirements;

3. not be tangible personal property used in the trade or business of transporting persons or property (except for agricultural or firefighting purposes);

4. be purchased by a purchaser who, at the time of the contract for purchase, has made a nonrefundable deposit of the lesser of ten percent of the cost or $100,000; and

5. have an estimated production period exceeding four months and a cost exceeding $200,000.

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

### *Explanation of Provision*

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

### *Effective Date*

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

# TITLE II—TAX BENEFITS RELATED TO HURRICANES RITA AND WILMA

## A. Special Rules for Use of Retirement Funds (sec. 201 of the Act and new sec. 1400Q of the Code)

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

#### *Present Law*

***In general***

Under present law, a distribution from a qualified retirement plan under section 401(a), a qualified annuity plan under section 403(a), a tax-sheltered annuity under section 403(b) (a "403(b) annuity"), an eligible deferred compensation plan maintained by a State or local government under section 457 (a "governmental 457 plan"), or an individual retirement arrangement under section 408 (an "IRA") generally is included in income for the year distributed (secs. 402(a), 403(a), 403(b), 408(d), and 457(a)). (These plans are referred to collectively as "eligible retirement plans".) In addition, a distribution from a qualified retirement or annuity plan, a 403(b) annuity, or an IRA received before age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception applies (sec. 72(t)).

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

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

Certain amounts held in a qualified retirement plan that includes a qualified cash-or-deferred arrangement (a "401(k) plan") or in a 403(b) annuity may not be distributed before severance from employment, age 59½, death, disability, or financial hardship of the employee. Amounts deferred under a governmental 457 plan

may not be distributed before severance from employment, age 70½, or an unforeseeable emergency of the employee.

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

The Katrina Emergency Tax Relief Act of 2005 (Public Law 109–73) provides an exception to the 10-percent early withdrawal tax in the case of a qualified Hurricane Katrina distribution from a qualified retirement or annuity plan, a 403(b) annuity, or an IRA. In addition, as discussed more fully below, income attributable to a qualified Hurricane Katrina distribution may be included in income ratably over three years, and the amount of a qualified Hurricane Katrina distribution may be recontributed to an eligible retirement plan within three years.

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

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

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

A qualified Hurricane Katrina distribution is a permissible distribution from a 401(k) plan, 403(b) annuity, or governmental 457 plan, regardless of whether a distribution would otherwise be permissible. A plan is not treated as violating any Code requirement

merely because it treats a distribution as a qualified Hurricane Katrina distribution, provided that the aggregate amount of such distributions from plans maintained by the employer and members of the employer's controlled group does not exceed $100,000. Thus, a plan is not treated as violating any Code requirement merely because an individual might receive total distributions in excess of $100,000, taking into account distributions from plans of other employers or IRAs.

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

### *Explanation of Provision*

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

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

### *Effective Date*

The provision is effective on the date of enactment (December 22, 2005).

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

### *Present Law*

#### *In general*

Under present law, a distribution from a qualified retirement plan, a tax-sheltered annuity (a "403(b) annuity"), or an individual retirement arrangement (an "IRA") generally is included in income for the year distributed (secs. 402(a), 403(b), and 408(d)). In addition, a distribution from a qualified retirement plan, a 403(b) annuity, or an IRA received before age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception applies (sec. 72(t)). An exception to the 10-percent tax applies in the case of a

qualified first-time homebuyer distribution from an IRA, i.e., a distribution (not to exceed $10,000) used within 120 days for the purchase or construction of a principal residence of a first-time homebuyer.

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

Certain amounts held in a qualified retirement plan that includes a qualified cash-or-deferred arrangement (a "401(k) plan") or a 403(b) annuity may not be distributed before severance from employment, age 59½, death, disability, or financial hardship of the employee. For this purpose, subject to certain conditions, distributions for costs directly related to the purchase of a principal residence by an employee (excluding mortgage payments) are deemed to be distributions on account of financial hardship.

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

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

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

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

## *Explanation of Provision*

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

A qualified Hurricane Rita distribution is a hardship distribution from a 401(k) plan or 403(b) annuity, or a qualified first-time homebuyer distribution from an IRA: (1) that is received after February 28, 2005, and before September 24, 2005; and (2) that was to be used to purchase or construct a principal residence in the

Hurricane Rita disaster area, but the residence is not purchased or constructed on account of Hurricane Rita. Any portion of a qualified Hurricane Rita distribution may, during the period beginning on September 23, 2005, and ending on February 28, 2006, be recontributed to a plan, annuity or IRA to which a rollover is permitted.

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

### *Effective Date*

The provision is effective on the date of enactment (December 22, 2005).

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

### *Present Law*

#### *In general*

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

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

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

participant. Plan loan repayments (principal and interest) must be amortized in level payments and made not less frequently than quarterly, over the term of the loan.

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

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

The exception to the general rule of income inclusion is provided to the extent that the loan (when added to the outstanding balance of all other loans to the participant from all plans maintained by the employer) does not exceed the lesser of (1) $100,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made or (2) the greater of $10,000 or the participant's accrued benefit under the plan.

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

## *Explanation of Provision*

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

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

A qualified Hurricane Wilma individual includes an individual whose principal place of abode on October 23, 2005, is located in a Hurricane Wilma disaster area and who has sustained an economic loss by reason of Hurricane Wilma. In the case of a qualified Hurricane Wilma individual with an outstanding loan on or after October 23, 2005, from a qualified employer plan, if the due date

for any repayment with respect to such loan occurs during the period beginning on October 23, 2005, and ending on December 31, 2006, such due date is delayed for one year.

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

### *Effective Date*

The provision is effective on the date of enactment (December 22, 2005).

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

### *Present Law*

#### *In general*

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

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

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

### *Explanation of Provision*

The provision codifies and expands the ability to make retroactive plan amendments under the Katrina Emergency Tax Relief

Act of 2005 to apply to changes made pursuant to new section 1400Q of the Code, or regulations issued thereunder.

### *Effective Date*

The provision is effective on the date of enactment (December 22, 2005).

## B. Employee Retention Credit for Employers Affected by Hurricanes Katrina, Rita, and Wilma (sec. 201 of the Act and new sec. 1400R of the Code)

### *Present Law*

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

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

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

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

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

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

### *Explanation of Provision*

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

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

### *Effective Date*

The codification of the provision in the Katrina Emergency Tax Relief Act of 2005 takes effect on the date of enactment (December 22, 2005). The provision that repeals the employer size limitation is, with respect to the Hurricane Katrina retention credit, effective as if included in the Katrina Emergency Tax Relief Act of 2005. The retention credit is effective for wages paid after September 23, 2005, in the case of Hurricane Rita and after October 23, 2005, in the case of Hurricane Wilma.

## C. Temporary Suspension of Limitations on Charitable Contributions (sec. 201 of the Act and new sec. 1400S(a) of the Code)

### *Present Law*

#### *In general*

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

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

***Percentage limitations***

*Contributions by individuals*

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

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

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

*Contributions by corporations*

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

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

*Carryforward of excess contributions*

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

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

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

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

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

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

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

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

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

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

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

### *Limitation on overall itemized deductions*

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

### *Explanation of Provision*

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

### *Effective Date*

The codification of the provision in the Katrina Emergency Tax Relief Act of 2005 takes effect on date of enactment (December 22, 2005). The expansion of the provision applies to contributions made on or after September 23, 2005.

## D. Suspension of Certain Limitations on Personal Casualty Losses (sec. 201 of the Act and new section 1400S(b) of the Code)

### *Present Law*

#### *In general*

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

#### *Hurricane Katrina*

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

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

### *Explanation of Provision*

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

### *Effective Date*

The codification of the provision in the Katrina Emergency Tax Relief Act of 2005 takes effect on date of enactment (December 22, 2005). The expansion of the provision applies to losses related to Hurricane Rita arising on or after September 23, 2005, and to losses related to Hurricane Wilma arising on or after October 23, 2005.

## E. Required Exercise of IRS Administrative Authority (sec. 201 of the Act and new sec. 1400S(c) of the Code)

### *Present Law*

#### *General time limits for filing tax returns*

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

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

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

#### *Suspension of time periods*

In general, the period of time for performing various acts under the Code, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, is suspended for any individual serving in the Armed Forces of the United States in an area designated as a "combat zone" or when deployed outside the United States away from the individual's permanent duty station while participating in an operation designated by the Secretary of Defense as a "contingency operation" or that becomes a contingency operation. The suspension of time also applies to an individual serving in support of such Armed Forces in the combat zone or contingency operation,

such as Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those Forces. The designation of a combat zone must be made by the President in an Executive Order. A contingency operation is defined as a military operation that is designated by the Secretary of Defense as an operation in which members of the Armed Forces are or may become involved in military actions, operations, or hostilities against an enemy of the United States or against an opposing military force, or results in the call or order to (or retention of) active duty of members of the uniformed services during a war or a national emergency declared by the President or Congress.

The suspension of time encompasses the period of service in the combat zone during the period of combatant activities in the zone or while participating in a contingency operation, as well as (1) any time of continuous qualified hospitalization resulting from injury received in the combat zone or contingency operation or (2) time in missing in action status, plus the next 180 days.

The suspension of time applies to the following acts:

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

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

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective on the date of enactment (December 22, 2005).

## F. Special Look-Back Rule for Determining Earned Income Credit and Refundable Child Credit (sec. 201 of the Act and new sec. 1400S(d) of the Code)

### *Present Law*

#### *In general*

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

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

#### *Hurricane Katrina*

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

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

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

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

### *Explanation of Provision*

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

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

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

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

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

### *Effective Date*

The codification of the provision in the Katrina Emergency Tax Relief Act of 2005 takes effect on date of enactment (December 22, 2005). The expansion of the provision applies to taxable years that

include September 23, 2005, in the case of Hurricane Rita and October 23, 2005, in the case of Hurricane Wilma.

### G. Secretarial Authority to Make Adjustments Regarding Taxpayer and Dependency Status (sec. 201 of the Act and new sec. 1400S(e) of the Code)

#### *Present Law*

***In general***

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

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

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

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

### *Hurricane Katrina*

With respect to taxable years beginning in 2005 and 2006, the Secretary has authority to make such adjustments in the application of the Federal tax laws as may be necessary to ensure that taxpayers do not lose any deduction or credit or experience a change of filing status by reason of temporary relocations caused by Hurricane Katrina. Such adjustments may include, for example, addressing the application of the residency requirements relating to dependency exemptions in the case of relocations due to Hurricane Katrina. Any adjustments made using this authority must insure that an individual is not taken into account by more than one taxpayer with respect to the same tax benefit.

### *Explanation of Provision*

The provision codifies the Secretarial authority with respect to Hurricane Katrina. The provision also expands the Secretary's authority to make adjustments in the application of the Federal tax laws with respect to Hurricane Katrina to include taxpayers affected by Hurricane Rita and Hurricane Wilma. The provision applies with respect to taxable years beginning in 2005 or 2006.

### *Effective Date*

The provision is effective on the date of enactment (December 22, 2005).

## H. Special Rules for Mortgage Revenue Bonds (sec. 201 of the Act and new sec. 1400T of the Code)

### *Present Law*

### *In general*

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

### *Qualified mortgage bonds*

The definition of a qualified private activity bond includes a qualified mortgage bond (sec. 143). Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for eligible mortgagors, purchase price limitations on the home financed with bond proceeds, and a "first-time homebuyer" requirement. The income limitations are satisfied

if all financing provided by an issue is provided for mortgagors whose family income does not exceed 115 percent of the median family income for the metropolitan area or State, whichever is greater, in which the financed residences are located. The purchase price limitations provide that a residence financed with qualified mortgage bonds may not have a purchase price in excess of 90 percent of the average area purchase price for that residence. The first-time homebuyer requirement provides qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement).

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

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

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

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

### *Explanation of Provision*

Under the provision, residences located in the GO Zone, the Rita GO Zone, or the Wilma GO Zone are treated as targeted area resi-

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

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

### *Effective Date*

The provision is effective on the date of enactment (December 22, 2005).

## TITLE III—OTHER PROVISIONS

### A. Gulf Coast Recovery Bonds (sec. 301 of the Act)

#### *Present Law*

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

#### *Explanation of Provision*

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

#### *Effective Date*

The provision is effective on the date of enactment (December 22, 2005).

### B. Election to Treat Combat Pay as Earned Income for Purposes of the Earned Income Credit (sec. 302 of the Act and sec. 32 of the Code)

#### *Present Law*

***Child credit***

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

***Earned income credit***

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

### *Explanation of Provision*[264]

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

### *Effective Date*

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

## C. Modifications of Suspension of Interest and Penalties Where Internal Revenue Service Fails to Contact Taxpayer (sec. 303 of the Act and sec. 6404(g) of the Code)

### *Present Law*

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

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

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

### *Explanation of Provision*

Under the provision, the exception for listed transactions and undisclosed reportable transactions also applies to interest accruing on or before October 3, 2004. However, taxpayers remain eligible for the present-law suspension of interest if the year in which the underpayment occurred is barred by the statute of limitations (or

[264] The provision was subsequently extended in Division A, section 106 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

a closing agreement) as of December 14, 2005. Taxpayers may also remain eligible with respect to a transactions if the Secretary determines that the taxpayers has acted reasonably and in good faith with respect to that transactions.

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

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

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

### *Effective Date*

The provision is effective as if included in the provisions of the American Jobs Creation Act of 2004 to which it relates, except that the rule relating to the restart of the 18-month period is effective for documents provided on or after the date of enactment (December 22, 2005).

## D. Authority for Undercover Operations (sec. 304 of the Act and sec. 7608 of the Code)

### *Present Law*

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

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

### *Explanation of Provision*[265]

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

### *Effective Date*

The provision is effective on the date of enactment (December 22, 2005).

## E. Disclosures of Certain Tax Return Information

### 1. Disclosure of tax information to facilitate combined employment tax reporting (sec. 305 of the Act and sec. 6103(d)(5) of the Code)

### *Present Law*

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

The authority for this program expires December 31, 2005.

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

---

[265] The provision was subsequently extended in Division A, section 121 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

### *Explanation of Provision*[266]

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

### *Effective Date*

The provision applies to disclosures after December 31, 2005.

## 2. Disclosure of return information regarding terrorist activities (sec. 305 of the Act and sec. 6103(i)(3) and (i)(7) of the Code)

### *Present Law*

#### *In general*

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

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

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

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

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

The Code permits, pursuant to an ex parte court order, the disclosure of returns and return information (including taxpayer return information) to certain officers and employees of a Federal law enforcement agency or Federal intelligence agency. These officers and employees are required to be personally and directly engaged

[266] The provision was subsequently extended in Division A, section 122 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

in any investigation of, response to, or analysis of intelligence and counterintelligence information concerning any terrorist incident, threat, or activity. These officers and employees are permitted to use this information solely for their use in the investigation, response, or analysis, and in any judicial, administrative, or grand jury proceeding, pertaining to any such terrorist incident, threat, or activity.

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

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

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

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

*Disclosure by the IRS without a request*

The Code permits the IRS to disclose return information, other than taxpayer return information, related to a terrorist incident, threat, or activity to the extent necessary to apprise the head of the appropriate Federal law enforcement agency responsible for investigating or responding to such terrorist incident, threat, or activity. The IRS on its own initiative and without a written request may

make this disclosure. The head of the Federal law enforcement agency may disclose information to officers and employees of such agency to the extent necessary to investigate or respond to such terrorist incident, threat, or activity. A taxpayer's identity is not treated as return information supplied by the taxpayer or his or her representative.

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

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

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

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

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

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

### *Explanation of Provision*[267]

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

### *Effective Date*

The provision applies to disclosures after December 31, 2005.

## 3. Disclosure of return information to carry out income contingent repayment of student loans (sec. 305 of the Act and sec. 6103(l)(13) of the Code)

### *Present Law*

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

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

### *Explanation of Provision*[268]

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

### *Effective Date*

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

---

[267] The provision was subsequently extended in Division A, section 122 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

[268] The provision was subsequently extended in Division A, section 122 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

## TITLE IV—TAX TECHNICAL CORRECTIONS

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

### A. Technical Corrections (secs. 401–412 of the Act)

***Amendments related to the Energy Policy Act of 2005***

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

*Deduction relating to income attributable to domestic production activities (manufacturing deduction) (Act sec. 102).*—With respect to the W–2 wage limitation on the allowable amount of the domestic production activities deduction, the Act does not require Forms W–2 actually to be filed, and does not specify whether the employees must be the common law employees of the taxpayer. The provision clarifies that a taxpayer may take into account only wages that are paid to the common law employees of the taxpayer and that are re-

ported on a Form W–2 filed with the Social Security Administration no later than 60 days after the extended due date for the Form W–2. Thus, the taxpayer may not take into account wages that were not actually reported. The provision also addresses situations in which the employer uses an agent to report its wages.

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

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

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

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

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

receipts, and any other items that are allocated to partners, are allocated among the partners in accordance with the requirements of section 199(d)(1) (as amended). Similarly, if a partner engages in such an activity with respect to property manufactured by the partnership, then the gross receipts derived from the activity are treated as domestic production gross receipts of the partner. The treatment of the partners and the partnership as a single taxpayer under this rule is only for the purpose of determining domestic production gross receipts.

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

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

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

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

The provision clarifies that unrelated business taxable income, rather than taxable income, applies for purposes of section 199(a)(1)(B) in computing the unrelated business income tax under

section 511. (In computing AMTI of an organization which is a corporation subject to tax under section 511(a), AMTI applies for purposes of section 199(a)(1)(B). In computing AMTI of an organization other than a corporation, the section 199 deduction is the same as for the regular tax. See sec. 199(d)(6).)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

*Railroad track maintenance credit (Act sec. 245).*—For purposes of the rule that prevents the claiming of the credit by more than one eligible taxpayer with respect to the same mile of track, the provision clarifies that Class II and Class III railroads that operate track under a lease are not required to obtain assignment from the track owner in order to utilize or assign the credit. Under the provision, the credit is limited in respect of the total number of miles of track 1(1) owned or leased by the Class II or Class III railroad and (2) assigned by the Class II or Class III railroad for purposes of the credit.

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

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

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

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

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

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

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

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

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

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

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

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

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

*Look-through rules to apply to dividends from noncontrolled section 902 corporations (Act sec. 403).*—The provision adds a transition rule under which a taxpayer may elect not to apply the Act's

look-through rules to taxable years beginning before January 1, 2005.

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

*Repeal of foreign personal holding company rules and foreign investment company rules (Act sec. 413).*—The provision repeals as deadwood Code section 532(b)(2), which coordinated the foreign personal holding company and accumulated earnings tax regimes, and instead provides that in computing a corporation's accumulated taxable income, a deduction is allowed in the amount of any income of the corporation that resulted in an inclusion for a U.S. shareholder under Code section 951(a). In the case of a corporation that is otherwise subject to the accumulated earnings tax on a gross basis (under Treas. Reg. sec. 1.535–1(b)), appropriate adjustments are made to this deductible amount to take into account deductions that may have reduced the inclusion under Code section 951(a), but which would not otherwise have been allowable in computing accumulated taxable income. For example, in the case of a corporation that is generally subject to the accumulated earnings tax on a gross basis, if Code section 954(b)(5) has had the effect of reducing the amount of a subpart F inclusion, it would be appropriate to reduce accumulated taxable income by the amount that would have been included under Code section 951(a) without applying Code section 954(b)(5).

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

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

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

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

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

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

*Incentives to reinvest foreign earnings in the United States (Act sec. 422).*—The provision amends Code section 965(a)(2)(B) to clarify that distributions made indirectly through tiers of controlled foreign corporations are eligible for the benefits of Code section 965 only if they originate with a dividend received by one controlled foreign corporation from another controlled foreign corporation in the same chain of ownership described in Code section 958(a). Thus, the first dividend in the sequence cannot be a portfolio dividend received by a controlled foreign corporation, for example.

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

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

For example, if a U.S. shareholder, as part of a plan to avoid the purposes of Code section 965(b)(3), contributes cash or other property to a controlled foreign corporation and then has the controlled foreign corporation pay a dividend to the U.S. shareholder (either to meet the base period repatriation level or as a dividend described in Code section 965(a)), or has the controlled foreign corporation lend the cash or other property to another controlled foreign corporation which then pays a dividend to the U.S. shareholder, regulations issued under this authority may require the U.S. shareholder to reduce its Code section 965(a) qualifying divi-

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

It is anticipated that many other transfers of cash or other property will not be regarded as effectively funding dividend repatriations for purposes of this regulatory authority. For example, if a U.S. shareholder, in the ordinary course of its trade or business, transfers cash or other property to a controlled foreign corporation in exchange for property or the provision of services, such a transfer will not be considered to have a principal purpose of avoiding the purposes of Code section 965(b)(3). Likewise, if a related person transfers cash to a controlled foreign corporation in a sale of assets by the controlled foreign corporation to the related person for non-tax business purposes, such a transfer will not be considered to have a principal purpose of avoiding the purposes of Code section 965(b)(3). Similarly, a transfer of cash or other property to a controlled foreign corporation for purposes of providing initial or ongoing working capital to the controlled foreign corporation or expanding the controlled foreign corporation's operations will not be considered to have a principal purpose of avoiding the purposes of Code section 965(b)(3). In addition, a transfer by a U.S. shareholder in repayment of an obligation owed to a controlled foreign corporation will not be considered to have a principal purpose of avoiding the purposes of Code section 965(b)(3), absent special circumstances indicating that the U.S. shareholder is using the repayment effectively to fund the dividend repatriation. It is expected that these special circumstances would not be found to exist in cases involving the repayment of short-term debt (i.e., debt with a term of no more than three years).

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

The provision also clarifies the definition of "applicable financial statement" under Code section 965(c)(1). In the case of a U.S. shareholder that is required to file a financial statement with the Securities and Exchange Commission (or is included in such a statement filed by another person), the provision clarifies that the applicable financial statement is the most recent audited annual statement that was so filed and certified on or before June 30, 2003. For purposes of this rule, a restatement of a previously filed and certified financial statement that occurs after June 30, 2003 does not alter the statement's status as having been filed and cer-

tified on or before June 30, 2003. In addition, the provision clarifies that the term "applicable financial statement" includes the notes that form an integral part of the financial statement; other materials, including work papers or materials that may be filed for some purposes with a financial statement but that do not form an integral part of such statement, may not be relied upon for purposes of producing an earnings or tax number under the provision. For example, if a note that is an integral part of an applicable financial statement states that the U.S. shareholder has not provided for deferred taxes on $1 billion of undistributed earnings of foreign subsidiaries because such earnings are intended to be reinvested permanently (or indefinitely) abroad, the U.S. shareholder's limit under Code section 965(b)(1) is $1 billion. If an applicable financial statement does not show a specific earnings or tax amount described in Code section 965(b)(1)(B) or (C), a taxpayer cannot rely on underlying work papers or other materials that are not a part of the financial statement to derive such an amount. If an applicable financial statement states that an earnings or tax amount is indeterminate (or that determination of a specific amount of earnings or taxes is not feasible), then the earnings or tax amount so described is treated as being zero. A specific earnings or tax amount can be relied upon for purposes of Code section 965(b)(1) as long as such amount is presented on the applicable financial statement as satisfying the indefinite reversal criterion of Accounting Principles Board Opinion 23 ("APB 23") relating to deferred taxes on undistributed foreign earnings, and is disclosed as required under Financial Accounting Standards Board Statement 109 ("FAS 109"), regardless of whether the exact words "permanently reinvested" are used, and regardless of whether APB 23 or FAS 109 is cited by name.

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

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

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

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

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

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

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

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

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

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

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

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

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

tion 6662 penalty amount is increased under section 6662(h) because the substantial valuation misstatement is determined to be a gross valuation misstatement).) The provision clarifies that accuracy-related penalties under section 6662A do not apply to underpayments to which a fraud penalty under section 6663 is applied.

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

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

*Material advisor list maintenance requirement and penalty (Act sec. 815).*—The provision clarifies that the penalty under section 6708 for failing to comply with the section 6112 list maintenance requirements applies to both (1) material advisors with respect to reportable transactions under present-law section 6112, and (2) organizers and sellers of potentially abusive tax shelters under prior-law section 6112. (This provision also would clarify the determination of the date on which a material advisor satisfies the list maintenance requirements for purposes of the extended statute of limitations for undisclosed listed transactions under section 814 of the Act.)

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

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

*Repeal of special rules for FASITs and modifications to rules for REMICs (Act sec. 835).*—The provision clarifies that, if more than 50 percent of the obligations transferred to, or purchased by, a REMIC are originated by a government entity and are principally secured by an interest in real property, then each obligation originated by a government entity and transferred to, or purposed by,

the REMIC is treated as principally secured by an interest in real property. Thus, the provision more closely aligns this rule with the "principally secured" standard that generally is provided by the definition of a qualified mortgage, and the provision clarifies that the treatment of obligations as principally secured by an interest in real property under this rule does not extend to obligations that are not originated by a government entity.

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

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

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

*Limitation on deductions allocable to property used by tax-exempt entities (Act sec. 849).*—The Act establishes rules to limit deductions that are allocable to tax-exempt use property. For this purpose, the Act generally defines "tax-exempt use property" by reference to the definition provided in section 168(h). Section 168(h) generally provides that tax-exempt use property includes tangible property that is leased to a tax-exempt entity, as well as certain property owned by a partnership that has a tax-exempt partner and provides for certain special allocations. The provision clarifies that the deduction limitation rules established by the Act apply without regard to whether the tax-exempt use property is treated as such by reason of a lease or otherwise (e.g., because the property is owned by a partnership that has a tax-exempt partner and provides for certain special allocations). In the case of property treated as tax-exempt use property other than by reason of a lease, the provision clarifies that the deduction limitation rules generally are effective for property acquired after March 12, 2004.

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

*Nonqualified deferred compensation plans (Act sec. 885).*—The provision clarifies that the additional tax and interest under the

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

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

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

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

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

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

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

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

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

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

*Bonus depreciation (Act sec. 201).*—Present-law rules for additional first-year depreciation provide criteria under which certain noncommercial aircraft, and certain property having longer production periods (as described in Code section 168(k)(2)(B)), can qualify for the extended placed-in-service date. The provision clarifies that property acquired and placed in service during 2005 pursuant to a written binding contract which was entered into after May 5, 2003, and before January 1, 2005, is eligible for 50-percent additional first-year depreciation deduction.

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

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

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

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

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

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

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

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

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

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

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

spect to the stock of higher-tier controlled foreign corporations in the same chain of ownership.

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

### *Amendment related to the Omnibus Budget Reconciliation Act of 1990*

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

### *Amendment related to the Omnibus Budget Reconciliation Act of 1987*

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

### *Clerical amendments*

The provisions include clerical and typographical amendments to the Code, which are effective upon enactment (December 22, 2005).

## B. Other Corrections (sec. 413 of the Act)

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

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

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

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

## PART TEN: EXTENSION OF PARITY IN THE APPLICATION OF CERTAIN LIMITS TO MENTAL HEALTH BENEFITS (PUBLIC LAW 109–151)[269]

### A. Extension of Parity in the Application of Certain Limits to Mental Health Benefits (sec. 1 of the Act and sec. 9812(f)(3) of the Code, sec. 712(f) of ERISA and sec. 2705(f) of the PHSA)

#### *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.

[269] H.R. 4579. The House passed the bill on the suspension calendar on December 17, 2005. The Senate passed the bill by unanimous consent on December 22, 2005. The President signed the bill on December 30, 2005.

### *Explanation of Provision*[270]

The provision extends the present-law Code excise tax for failure to comply with the mental health parity requirements through December 31, 2006. It also extends the ERISA and PHSA requirements through December 31, 2006.

### *Effective Date*

The provision is effective on date of enactment (December 30, 2005).

[270] The provision was subsequently extended in Division A, section 115 of the Tax Relief and Health Care Act of 2006, Pub. L. 109–432, described in Part Fourteen.

# PART ELEVEN: TAX INCREASE PREVENTION AND RECONCILIATION ACT OF 2005 (PUBLIC LAW 109–222)[271]

## TITLE I—EXTENSION AND MODIFICATION OF CERTAIN PROVISIONS

### A. Extension of Increased Expensing for Small Business (sec. 101 of the Act and sec. 179 of the Code)

#### *Present Law*

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs. Present law provides that the maximum amount a taxpayer may expense, for taxable years beginning in 2003 through 2007, is $100,000 of the cost of qualifying property placed in service for the taxable year.[272] 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.

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.[273]

For taxable years beginning in 2008 and thereafter (or before 2003), the following rules apply. A taxpayer with a sufficiently

[271] H.R. 4297. The House Committee on Ways and Means reported the bill on November 11, 2005 (H.R. Rep. No. 109–304). The House passed the bill on December 8, 2005. The Senate Committee on Finance reported S. 2020 on November 16, 2005. The Senate passed S. 2020 on November 18, 2005. The Senate passed H.R. 4297, as amended by the provisions of S. 2020, on February 2, 2006. The conference report was filed on May 9, 2006 (H.R. Rep. No. 109–455). The House passed the conference report on May 10, 2006, and the Senate passed the conference report on May 11, 2006. The President signed the bill on May 17, 2006.

[272] 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).

[273] 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.

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.[274]

### *Reasons for Change*

The Congress believes that section 179 expensing provides two important benefits for small businesses. First, it lowers the cost of capital for property used in a trade or business. With a lower cost of capital, the Congress believes small businesses will invest in more equipment and employ more workers. Second, it eliminates depreciation recordkeeping requirements with respect to expensed property. In 2004, Congress acted to increase the value of these benefits and to increase the number of taxpayers eligible for taxable years through 2007. The Congress believes that the changes to section 179 expensing will continue to provide important benefits if extended, and the Act therefore extends these changes for an additional two years.

### *Explanation of Provision*

The Act extends for 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 provision, these present-law rules continue in effect for taxable years beginning after 2007 and before 2010.

### *Effective Date*

The provision is effective for taxable years beginning after 2007.

## B. Reduced Rates for Capital Gains and Dividends of Individuals (sec. 102 of the Act and sec. 1(h) of the Code)

### *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 generally 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.

[274] Sec. 179(c)(2).

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 excess of the sum of 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) and an amount of gain equal to the additional amount of gain that would be excluded from gross income under section 1202 (relating to certain small business stock) if the percentage limitations of section 1202(a) did not apply), over the sum of 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 may not exceed the net section 1231 gain for the year.

An individual's 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 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, that 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 capital gains. 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 cor-

poration 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 RIC 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.[275]

*Tax rates after 2008*

For taxable years beginning after 2008, dividends received by an individual are taxed at ordinary income tax rates.

[275] In addition, for taxable years beginning before 2009, 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; the tax rate for the accumulated earnings tax (sec. 531) and the personal holding company tax (sec. 541) is reduced to 15 percent; and the collapsible corporation rules (sec. 341) are repealed.

### *Reasons for Change*

The Congress believes that the lower capital gain and dividend rates have had a positive effect on the economy and should be extended to continue to promote economic growth by increasing the after-tax return to saving and investment. The Congress further believes that the extension will encourage the payment of dividends by corporations.

### *Explanation of Provision*

The Act extends for two years the present-law provisions relating to lower capital gain and dividend tax rates (through taxable years beginning on or before December 31, 2010).

### *Effective Date*

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

## C. Controlled Foreign Corporations

### 1. Subpart F exception for active financing income (sec. 103(a) of the Act and secs. 953 and 954 of the Code)

### *Present Law*

Under the subpart F rules, 10-percent U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, insurance income and foreign base company income. Foreign base company income includes, among other things, foreign personal holding company income and foreign base company services income (i.e., income derived from services performed for or on behalf of a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insur-

ance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income.[276]

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").[277]

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of insurance, in addition to a temporary exception from foreign personal holding company income for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, certain temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met.

In the case of a life insurance or annuity contract, reserves for such contracts are determined as follows for purposes of these provisions. The reserves equal the greater of: (1) the net surrender value of the contract (as defined in section 807(e)(1)(A)), including in the case of pension plan contracts; or (2) the amount determined by applying the tax reserve method that would apply if the qualifying life insurance company were subject to tax under Subchapter

[276] Prop. Treas. Reg. sec. 1.953–1(a).

[277] Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998. Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999. The Tax Relief Extension Act of 1999 (Pub. L. No. 106–170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002. The Job Creation and Worker Assistance Act of 2002 (Pub. L. No. 107–147) modified and extended the temporary exceptions for five years, for taxable years beginning after 2001 and before 2007.

L of the Code, with the following modifications. First, there is substituted for the applicable Federal interest rate an interest rate determined for the functional currency of the qualifying insurance company's home country, calculated (except as provided by the Treasury Secretary in order to address insufficient data and similar problems) in the same manner as the mid-term applicable Federal interest rate (within the meaning of section 1274(d)). Second, there is substituted for the prevailing State assumed rate the highest assumed interest rate permitted to be used for purposes of determining statement reserves in the foreign country for the contract. Third, in lieu of U.S. mortality and morbidity tables, mortality and morbidity tables are applied that reasonably reflect the current mortality and morbidity risks in the foreign country. Fourth, the Treasury Secretary may provide that the interest rate and mortality and morbidity tables of a qualifying insurance company may be used for one or more of its branches when appropriate. In no event may the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe, equalization, or deficiency reserve or any similar reserve.

Present law permits a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes. In seeking a ruling, the taxpayer is required to provide the IRS with necessary and appropriate information as to the method, interest rate, mortality and morbidity assumptions and other assumptions under the foreign reserve rules so that a comparison can be made to the reserve amount determined by applying the tax reserve method that would apply if the qualifying insurance company were subject to tax under Subchapter L of the Code (with the modifications provided under present law for purposes of these exceptions). The IRS also may issue published guidance indicating its approval. Present law continues to apply with respect to reserves for any life insurance or annuity contract for which the IRS has not approved the use of the foreign statement reserve. An IRS ruling request under this provision is subject to the present-law provisions relating to IRS user fees.

### *Reasons for Change*

In the Taxpayer Relief Act of 1997, one-year temporary exceptions from foreign personal holding company income were enacted for income from the active conduct of an insurance, banking, financing, or similar business. In 1998, 1999, and 2002, the provisions were extended, and in some cases, modified. The Congress believes that it is appropriate to extend the temporary provisions, as modified by the previous legislation, for an additional two years.

### *Explanation of Provision*

The Act extends for two years (for taxable years beginning before 2009) the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

### *Effective Date*

The provision is effective for taxable years of foreign corporations beginning after December 31, 2006, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

## 2. Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company income rules (sec. 103(b) of the Act and sec. 954(c) of the Code)

### *Present Law*

In general, the rules of subpart F (secs. 951–964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("CFC") to include certain income of the CFC (referred to as "subpart F income") on a current basis for U.S. tax purposes, regardless of whether the income is distributed to the shareholders.

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents, and royalties, among other types of income. However, foreign personal holding company income does not include dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized, or rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor.

### *Reasons for Change*

Most countries allow their companies to redeploy active foreign earnings with no additional tax burden. The Congress believes that this provision will make U.S. companies and U.S. workers more competitive with respect to such countries. By allowing U.S. companies to reinvest their active foreign earnings where they are most needed without incurring the immediate additional tax that companies based in many other countries never incur, the Congress believes that the provision will enable U.S. companies to make more sales overseas, and thus produce more goods in the United States.

### *Explanation of Provision*[278]

Under the Act, for taxable years beginning after 2005 and before 2009, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end, dividends, interest,[279] rents, and royalties received by one CFC from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to non-subpart-F income of the payor. For this purpose, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC's stock (by vote or value) constitutes control for these purposes. The Act provides that the Secretary shall prescribe such regulations as are appropriate to prevent the abuse of the purposes of this provision.

### *Effective Date*

The provision is effective for taxable years of foreign corporations beginning after December 31, 2005, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

[278] The provision was subsequently amended in Division A, section 426 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

[279] Interest for this purpose includes factoring income which is treated as equivalent to interest under sec. 954(c)(1)(E).

## TITLE II—OTHER PROVISIONS

### A. Taxation of Certain Settlement Funds (sec. 201 of the Act and sec. 468B of the Code)

#### *Present Law*

Present law provides that if a taxpayer makes a payment to a designated settlement fund pursuant to a court order, the deduction timing rules that require economic performance generally are deemed to be met as the payments are made by the taxpayer to the fund. A designated settlement fund means a fund which: is established pursuant to a court order; extinguishes completely the taxpayer's tort liability arising out of personal injury, death or property damage; is administered by persons a majority of whom are independent of the taxpayer; and under the terms of the fund the taxpayer (or any related person) may not hold any beneficial interest in the income or corpus of the fund.

Generally, a designated or qualified settlement fund is taxed as a separate entity at the maximum trust rate on its modified income. Modified income is generally gross income less deductions for administrative costs and other incidental expenses incurred in connection with the operation of the settlement fund.

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

Present law provides that nothing in any provision of law is to be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax.

#### *Reasons for Change*

The Congress believes that environmental escrow accounts established under court consent decrees are essential for the EPA to resolve or satisfy claims under the CERCLA. The tax treatment of these settlement funds may prevent taxpayers from entering into prompt settlements with the EPA for the cleanup of Superfund hazardous waste sites and reduce the ultimate amount of funds available for the sites' cleanup. Because these settlement funds are controlled by the government and, upon termination, any remaining funds belong to the government, the Congress believes it is appropriate to establish that these funds are to be treated as beneficially owned by the United States.

### *Explanation of Provision*[280]

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

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

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

### *Effective Date*

The provision is effective for accounts and funds established after the date of enactment (May 17, 2006).

## B. Modifications to Rules Relating to Taxation of Distributions of Stock and Securities of a Controlled Corporation (secs. 202 and 507 of the Act and sec. 355 of the Code)

### *Present Law*

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

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

One requirement to qualify for tax-free treatment under section 355 is that both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period (the "active business test").[281] For this purpose, a corporation is engaged in the active conduct of a trade or busi-

[280] The provision was subsequently made permanent in Division A, section 409 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

[281] Section 355(b).

ness only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) the corporation is not directly engaged in an active business, but substantially all its assets consist of stock and securities of one or more corporations that it controls that are engaged in the active conduct of a trade or business.[282]

In determining whether a corporation is directly engaged in an active trade or business that satisfies the requirement, old IRS guidelines for advance ruling purposes required that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least five percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[283] More recently, the IRS has suspended this specific rule in connection with its general administrative practice of moving IRS resources away from advance rulings on factual aspects of section 355 transactions in general.[284]

If the distributing or controlled corporation is not directly engaged in an active trade or business, then the IRS takes the position that the "substantially all" test as applied to that corporation requires that at least 90 percent of the fair market value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business.[285]

In determining whether assets are part of a five-year qualifying active business, assets acquired more recently than five years prior to the distribution, in a taxable transaction, are permitted to qualify as five-year "active business" assets if they are considered to have been acquired as part of an expansion of an existing business that does so qualify.[286]

When a corporation holds an interest in a partnership, IRS revenue rulings have allowed an active business of the partnership to count as an active business of a corporate partner in certain circumstances. One such case involved a situation in which the corporation owned at least 20 percent of the partnership, was actively engaged in management of the partnership, and the partnership itself had an active business.[287]

In addition to its active business requirements, section 355 does not apply to any transaction that is a "device" for the distribution of earnings and profits to a shareholder without the payment of tax on a dividend. A transaction is ordinarily not considered a "device" to avoid dividend tax if the distribution would have been treated by the shareholder as a redemption that was a sale or exchange of its stock, rather than as a dividend, if section 355 had not applied.[288]

---

[282] Section 355(b)(2)(A). The IRS takes the position that the statutory test requires that at least 90 percent of the fair market value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business. Rev. Proc. 96–30, sec. 4.03(5), 1996–1 C.B. 696; Rev. Proc. 77–37, sec. 3.04, 1977–2 C.B. 568.

[283] Rev. Proc. 2003–3, sec. 4.01(30), 2003–1 I.R.B. 113.

[284] Rev. Proc. 2003–48, 2003–29 I.R.B. 86.

[285] Rev. Proc. 96–30, sec. 4.03(5), 1996–1 C.B. 696; Rev. Proc. 77–37, sec. 3.04, 1977–2 C.B. 568.

[286] Treas. Reg. sec. 1.355–3(b)(ii).

[287] Rev. Rul. 92–17, 1002–1 C.B. 142; see also, Rev. Rul. 2002–49, 2002–2 C.B. 50.

[288] Treas. Reg. sec. 1.355–2(d)(5)(iv).

### *Reasons for Change*

Prior to a spin-off under section 355 of the Code, corporate groups that have conducted business in separate corporate entities often must undergo elaborate restructurings to place active businesses in the proper entities to satisfy the five-year active business requirement. If the top-tier corporation of a chain that is being spun off or retained is a holding company, then the requirements regarding the activities of its subsidiaries are more stringent than if the top-tier corporation itself engaged in some active business. The Congress believed that it is appropriate to simplify planning for corporate groups that use a holding company structure to engage in distributions that qualify for tax-free treatment under section 355.

### *Explanation of Provision*

Under the provision, the active business test is determined by reference to the relevant separate affiliated group. For the distributing corporation, the relevant separate affiliated group consists of the distributing corporation as the common parent and all corporations affiliated with the distributing corporation through stock ownership described in section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under section 1504(b)), immediately after the distribution. The relevant separate affiliated group for a controlled corporation is determined in a similar manner (with the controlled corporation as the common parent).

A separate part of the provision denies section 355 treatment if either the distributing or distributed corporation is a disqualified investment corporation immediately after the transaction (including any series of related transactions) and any person that did not hold 50 percent or more of the voting power or value of stock of such distributing or controlled corporation immediately before the transaction does hold a such a 50 percent or greater interest immediately after such transaction.[289] The attribution rules of section 318 apply for purposes of this determination.

A disqualified investment corporation is any distributing or controlled corporation if the fair market value of the investment assets of the corporation is two-thirds or more of the fair market value of all assets of the corporation (75 percent (three-quarters) for distributions occurring during the one-year period beginning on May 17, 2006, the date of enactment). Except as otherwise provided, the term "investment assets" for this purpose means (i) cash, (ii) any stock or securities in a corporation, (iii) any interest in a partnership, (iv) any debt instrument or other evidence of indebtedness; (v) any option, forward or futures contract, notional principal contract, or derivative; (vi) foreign currency, or (vii) any similar asset.

---

[289] The disqualified investment corporation provision applies when a person directly or indirectly holds 50 percent of either the vote or the value of a company immediately following a distribution, and such person did not hold such 50 percent interest directly or indirectly prior to the distribution. As one example, the provision applies if a person that held 50 percent or more of the vote, but not of the value, of a distributing corporation immediately prior to a transaction in which a controlled corporation that was 100 percent owned by that distributing corporation is distributed, directly or indirectly holds 50 percent of the value of either the distributing or controlled corporation immediately following such transaction.

The term "investment assets" does not include any asset which is held for use in the active and regular conduct of (i) a lending or finance business (as defined in section 954(h)(4)); (ii) a banking business through a bank (as defined in section 581), a domestic building and loan association (within the meaning of section 7701(a)(19)), or any similar institution specified by the Secretary; or (iii) an insurance business if the conduct of the business is licensed, authorized, or regulated by an applicable insurance regulatory body. These exceptions only apply with respect to any business if substantially all the income of the business is derived from persons who are not related (within the meaning of section 267(b) or 707(b)(1)) to the person conducting the business.

The term "investment assets" also does not include any security (as defined in section 475(c)(2)) which is held by a dealer in securities and to which section 475(a) applies.

The term "investment assets" also does not include any stock or securities in, or any debt instrument, evidence of indebtedness, option, forward or futures contract, notional principal contract, or derivative issued by, a corporation which is a 20-percent controlled entity with respect to the distributing or controlled corporation. Instead, the distributing or controlled corporation is treated as owning its ratable share of the assets of any 20-percent controlled entity.

The term 20-percent controlled entity means any corporation with respect to which the corporation in question (distributing or controlled) owns directly or indirectly stock possessing at least 20 percent of voting power and value, excluding stock that is not entitled to vote, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and is not convertible into another class of stock.

The term "investment assets" also does not include any interest in a partnership, or any debt instrument or other evidence of indebtedness issued by the partnership, if one or more trades or businesses of the partnership are, (or without regard to the 5-year requirement of section 355(b)(2)(B), would be) taken into account by the distributing or controlled corporation, as the case may be, in determining whether the active business test of section 355 is met by such corporation.

The Treasury department shall provide regulations as may be necessary to carry out, or prevent the avoidance of, the purposes of the provision, including regulations in cases involving related persons, intermediaries, pass-through entities, or other arrangements; and the treatment of assets unrelated to the trade or business of a corporation as investment assets if, prior to the distribution, investment assets were used to acquire such assets. Regulations may also in appropriate cases exclude from the application of the provision a distribution which does not have the character of a redemption and which would be treated as a sale or exchange

under section 302, and may modify the application of the attribution rules.[290]

### *Effective Date*

The first part of the provision, relating to the application of the active business requirement by reference to the relevant separate affiliated group, applies to distributions after May 17, 2006 (the date of enactment) and on or before December 31, 2010,[291] with three exceptions. The provision does not apply to distributions (1) made pursuant to an agreement which is binding on May 17, 2006, and at all times thereafter, (2) described in a ruling request submitted to the IRS on or before May 17, 2006, or (3) described on or before May 17, 2006 in a public announcement or in a filing with the Securities and Exchange Commission. The distributing corporation may irrevocably elect not to have the exceptions described above apply.

The relevant separate affiliated group part of the provision also applies, solely for the purpose of determining whether, after May 17, 2006, there is continuing qualification under the requirements of section 355(b)(2)(A) of distributions made before such date, as a result of an acquisition, disposition, or other restructuring after such date and on or before December 31, 2010.[292]

The part of the provision relating to transactions involving a disqualified investment corporation is effective for distributions after May 17, 2006, except in transactions which are (i) made pursuant to an agreement which was binding on May 17, 2006 enactment and at all times thereafter; (ii) described in a ruling request submitted to the Internal Revenue Service on or before such date, or (iii) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission.

## C. Qualified Veterans' Mortgage Bonds (sec. 203 of the Act and sec. 143 of the Code)

### *Present Law*

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

---

[290] The enumeration of specific situations that Treasury regulations may address is not intended to restrict or limit any other situations that Treasury may address under the general authority of new section 355(g)(5) to carry out, or prevent the avoidance of, the purposes of the disqualified investment corporation provision.

[291] The provision was subsequently made permanent in Division A, section 410 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

[292] For example, a holding company taxpayer that had distributed a controlled corporation in a spin-off before the date of enactment, in which spin-off the taxpayer satisfied the "substantially all" active business stock test of section 355(b)(2)(A) (as in effect before the date of enactment) immediately after the distribution, would not be deemed to have failed to satisfy any requirement that it continue that same qualified structure for any period of time after the distribution, solely because of a restructuring that occurs after May 17, 2006 and before January 1, 2011, and that would satisfy the requirements of new section 355(b)(2)(A). Under the extension of the effective date described in the immediately preceding footnote, the requirement that the restructuring occur before January 1, 2011 is removed.

vate activity bond includes both qualified mortgage bonds and qualified veterans' mortgage bonds.

Qualified veterans' mortgage bonds are private activity bonds the proceeds of which are used to make mortgage loans to certain veterans. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984. Qualified veterans' mortgage bonds are not subject to the State volume limitations generally applicable to private activity bonds. Instead, annual issuance in each State is subject to a State volume limitation based on the volume of such bonds issued by the State before June 22, 1984. The five States eligible to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin. Loans financed with qualified veterans' mortgage bonds can be made only with respect to principal residences and can not be made to acquire or replace existing mortgages. Mortgage loans made with the proceeds of these bonds can be made only to veterans who served on active duty before 1977 and who applied for the financing before the date 30 years after the last date on which such veteran left active service (the "eligibility period").

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

### *Reasons for Change*

The Congress believes that the qualified veterans' mortgage bond program should be expanded to more recent veterans including potentially the men and women serving on active duty today. The Congress also believes that such an expansion requires modified volume limits for these bonds.

### *Explanation of Provision*[293]

In the case of qualified veterans' mortgage bonds issued by the States of Alaska, Oregon, and Wisconsin, the provision repeals the requirement that veterans receiving loans financed with qualified veterans' mortgage bonds must have served before 1977. In addition, the provision reduces the eligibility period for applying for a loan following release from the military service to 25 years (rather than 30 years) for loans financed with bonds issued by the States of Alaska, Oregon, and Wisconsin.

The provision also provides new State volume limits for qualified veterans' mortgage bonds issued by the States of Alaska, Oregon, and Wisconsin. In 2010, the new annual limit on the total volume of veterans' bonds that may be issued by each of these three States is $25 million. These volume limits are phased-in over the four-year period immediately preceding 2010 by allowing the applicable

[293] The provision was subsequently made permanent in Division A, section 411 of the Tax Relief and Health Care Act of 2006, Pub. L. 109–432, described in Part Fourteen.

percentage of the 2010 volume limits. The following table provides those percentages.

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

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

The provision does not amend present law as it relates to qualified veterans' mortgage bonds issued by the States of California or Texas.

### *Effective Date*

The provision expanding the definition of eligible veterans applies to bonds issued on or after the date of enactment (May 17, 2006). The provision amending State volume limitations applies to allocations of volume limitation made after April 5, 2006.

## D. Capital Gains Treatment for Certain Self-Created Musical Works (sec. 204 of the Act and sec. 1221 of the Code)

### *Present Law*

#### *Capital gains*

The maximum tax rate on the net capital gain income of an individual is 15 percent for taxable years beginning in 2006. By contrast, the maximum tax rate on an individual's ordinary income is 35 percent. The reduced 15-percent rate generally is available for gain from the sale or exchange of a capital asset for which the taxpayer has satisfied a holding-period requirement. Capital assets generally include all property held by a taxpayer with certain specified exclusions.

An exclusion from the definition of a capital asset applies to inventory property or property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. Another exclusion from capital asset status applies to copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property held by a taxpayer whose personal efforts created the property (or held by a taxpayer whose basis in the property is determined by reference to the basis of the taxpayer whose personal efforts created the property). Consequently, when a taxpayer that owns copyrights in, for example, books, songs, or paintings that the taxpayer created (or when a taxpayer to which the copyrights have been transferred by the works' creator in a substituted basis transaction) sells the copyrights, gain from the sale is treated as ordinary income, not capital gain.

### *Charitable contributions*

A taxpayer generally is allowed a deduction for the fair market value of property contributed to a charity. If a taxpayer makes a contribution of property that would have generated ordinary income (or short-term capital gain), the taxpayer's charitable contribution deduction generally is limited to the property's adjusted basis.

### *Reasons for Change*

The Congress believes it is appropriate to allow taxpayers to treat as capital gain the income from a sale or exchange of musical compositions or copyrights in musical works the taxpayer created.

### *Explanation of Provision*[294]

The provision provides that at the election of a taxpayer, the sale or exchange before January 1, 2011 of musical compositions or copyrights in musical works created by the taxpayer's personal efforts (or having a basis determined by reference to the basis in the hands of the taxpayer whose personal efforts created the compositions or copyrights) is treated as the sale or exchange of a capital asset. The provision does not change the present law limitation on a taxpayer's charitable deduction for the contribution of those compositions or copyrights.

### *Effective Date*

The provision is effective for sales or exchanges in taxable years beginning after the date of enactment (May 17, 2006).

## E. Decrease Minimum Vessel Tonnage Limit to 6,000 Deadweight Tons (sec. 205 of the Act and sec. 1355 of the Code)

### *Present Law*

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

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

The United States imposes a four percent tax on the amount of a foreign corporation's U.S. source gross transportation income (sec. 887). Transportation income includes income from the use (or hir-

[294] The provision was subsequently made permanent in Division A, section 412 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

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

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

Notwithstanding the general rules described above, the American Jobs Creation Act of 2004 ("AJCA")[295] generally allows corporations that are qualifying vessel operators[296] to elect a "tonnage tax" in lieu of the corporate income tax on taxable income from certain shipping activities. Accordingly, an electing corporation's gross income does not include its income from qualifying shipping activities (and items of loss, deduction, or credit are disallowed with respect to such excluded income), and electing corporations are only subject to tax on these activities at the maximum corporate income tax rate on their notional shipping income, which is based on the net tonnage of the corporation's qualifying vessels.[297] No deductions are allowed against the notional shipping income of an electing corporation, and no credit is allowed against the notional tax imposed under the tonnage tax regime. In addition, special deferral rules apply to the gain on the sale of a qualifying vessel, if such vessel is replaced during a limited replacement period.

Generally, a "qualifying vessel" is defined as a self-propelled (or a combination of self-propelled and non-self-propelled) U.S.-flag vessel of not less than 10,000 deadweight tons[298] that is used exclusively in the U.S. foreign trade.

---

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

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

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

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

### *Reasons for Change*

The Congress believes that the tonnage tax regime provides operators of qualifying U.S.-flag vessels in the U.S. foreign trade the opportunity to be competitive with their tax-advantaged foreign competitors. However, there are a number of U.S.-flag vessels that are operated in the U.S. foreign trade but which do not qualify for tonnage tax treatment because their carrying capacity is less than 10,000 deadweight tons. The Congress believes that the expansion of the tonnage tax regime to smaller vessels will permit the operators of such vessels to be competitive with their foreign competitors as well as with their larger U.S.-flag competitors.

### *Explanation of Provision* [299]

The provision expands the definition of "qualifying vessel" to include self-propelled (or a combination of self-propelled and non-self-propelled) U.S. flag vessels of not less than 6,000 deadweight tons used exclusively in the United States foreign trade. The modified definition applies for taxable years beginning after December 31, 2005, and ending before January 1, 2011.

### *Effective Date*

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

## F. Modification of Special Arbitrage Rule for Certain Funds (sec. 206 of the Act)

### *Present Law*

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

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

[299] The provision was subsequently made permanent in Division A, section 413 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

to finance buildings and other permanent improvements were secured by and payable from the income of the Fund.

Prior to 1999, the constitution did not permit the expenditure or mortgage of the Fund for any purpose. In 1999, the State constitutional rules governing the Fund were modified with regard to the manner in which amounts in the Fund are distributed for the benefit of the two university systems. The State constitutional amendments allow for the possibility that in the event investment earnings are less than annual debt service on the bonds some of the debt service could be considered as having been paid with the Fund corpus. The 1984 exception refers only to bonds secured by investment earnings on securities or obligations held by the Fund. Despite the constitutional amendments, the IRS has agreed to continue to apply the 1984 exception to the Fund through August 31, 2007, if clarifying legislation is introduced in the 109th Congress prior to August 31, 2005. Clarifying legislation was introduced in the 109th Congress on May 26, 2005.[300]

### *Reasons for Change*

The Congress understands that the State constitutional amendments have the effect of permitting the Fund to make annual distributions in a manner similar to standard university endowment funds, rather than tying distributions to annual income performance, which can create a variable pattern of distributions. The Congress does not believe that the Fund should lose the benefits of the 1984 exception from the tax-exempt bond arbitrage restrictions by adopting a more modern approach to the management of Fund distributions.

### *Explanation of Provision*[301]

The provision codifies and extends the IRS agreement for bonds issued before August 31, 2009. The 1984 exception is conformed to the State constitutional amendments to permit its continued applicability to bonds of the two university systems. The limitation on the aggregate amount of bonds which may benefit from the exception is not modified, and remains at 20 percent of the value of the Fund.

### *Effective Date*

The provision is effective for bonds issued after the date of enactment (May 17, 2006).

## G. Amortization of Expenses Incurred in Creating or Acquiring Music or Music Copyrights (sec. 207 of the Act and sec. 167(g) of the Code)

### *Present Law*

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business

[300] H.R. 2661.

[301] The provision was subsequently made permanent in Division A, section 414 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

or for the production of income. Section 167(g) provides that the cost of motion picture films, sound recordings, copyrights, books, patents, and other property specified in regulations is eligible to be recovered using the income forecast method of depreciation.

Under the income forecast method, the depreciation deduction with respect to eligible property for a taxable year is determined by multiplying the adjusted basis of the property by a fraction, the numerator of which is the income generated by the property during the year, and the denominator of which is the total forecasted or estimated income expected to be generated prior to the close of the tenth taxable year after the year the property was placed in service. Any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year.

The adjusted basis of property that may be taken into account under the income forecast method includes only amounts that satisfy the economic performance standard of section 461(h) (except in the case of certain participations and residuals). In addition, taxpayers that claim depreciation deductions under the income forecast method are required to pay (or receive) interest based on a recalculation of depreciation under a "look-back" method.

The "look-back" method is applied in any "recomputation year" by (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of the Code. Except as provided in Treasury regulations, a "recomputation year" is the third and tenth taxable year after the taxable year the property was placed in service, unless the actual income from the property for each taxable year ending with or before the close of such years was within 10 percent of the estimated income from the property for such years.

A special rule is provided under Treasury guidance in the case of certain authors and other taxpayers, with respect to their capitalization of costs under section 263A and with respect to the recovery or amortization of such costs. Specifically, IRS Notice 88–62 (1988–1 C.B. 548) provides an elective safe harbor under which eligible taxpayers capitalize qualified created costs incurred during the taxable year and amortize 50 percent of the costs in the taxable year incurred, and 25 percent in each of the two successive taxable years. Under the Notice, qualified creative costs generally are those incurred by a self-employed individual in the production of creative properties (such as films, sound recordings, musical and dance compositions including accompanying words, and other similar properties), provided the personal efforts of the individual predominantly create the properties. An eligible taxpayer is an individual, and also a corporation or partnership, substantially all of which is owned by one qualified employee owner (an individual and family members).

### *Explanation of Provision*

The provision provides an election with respect to expenses paid or incurred with respect to musical compositions and related copyrights. Under the election, if any expense is paid or incurred by the taxpayer in creating or acquiring any musical composition (including accompanying words) or any copyright with respect to a musical composition that is required to be capitalized, then the income forecast method does not apply to such expenses, but rather, the expenses are amortized over a five-year period. The five-year period is the period beginning with the month in which the composition or copyright is placed in service.

The election applies on a taxable year basis and may be made for any taxable year which begins before January 1, 2011. Thus, a taxpayer that places in service any musical composition or copyright with respect to a musical composition in a taxable year may elect to apply the provision with respect to all musical compositions and musical composition copyrights placed in service in that taxable year. An eligible taxpayer that does not make the election may recover the costs under any method allowable under present law, including the income forecast method.

The provision does not apply to certain expenses. The expenses to which it does not apply are expenses: (1) that are qualified creative expenses under section 263A(h); (2) to which a simplified procedure established under section 263A(j)(2) applies; (3) that are an amortizable section 197 intangible; or (4) that, without regard to this provision, would not be allowable as a deduction.

### *Effective Date*

The provision is effective for expenses paid or incurred with respect to property placed in service in taxable years beginning after December 31, 2005.

## H. Capital Expenditure Limitation for Qualified Small Issue Bonds (sec. 208 of the Act and sec. 144 of the Code)

### *Present Law*

Qualified small-issue bonds are tax-exempt State and local government bonds used to finance private business manufacturing facilities (including certain directly related and ancillary facilities) or the acquisition of land and equipment by certain farmers. In both instances, these bonds are subject to limits on the amount of financing that may be provided, both for a single borrowing and in the aggregate. In general, no more than $1 million of small-issue bond financing may be outstanding at any time for property of a business (including related parties) located in the same municipality or county. Generally, this $1 million limit may be increased to $10 million if all other capital expenditures of the business in the same municipality or county are counted toward the limit over a six-year period that begins three years before the issue date of the bonds and ends three years after such date. Outstanding aggregate borrowing is limited to $40 million per borrower (including related parties) regardless of where the property is located.

For bonds issued after September 30, 2009, the Code permits up to $10 million of capital expenditures to be disregarded, in effect increasing from $10 million to $20 million the maximum allowable amount of total capital expenditures by an eligible business in the same municipality or county.[302] However, no more than $10 million of bond financing may be outstanding at any time for property of an eligible business (including related parties) located in the same municipality or county. Other limits (e.g., the $40 million per borrower limit) also continue to apply.

### *Explanation of Provision*

The provision accelerates the application of the $20 million capital expenditure limitation from bonds issued after September 30, 2009, to bonds issued after December 31, 2006.

### *Effective Date*

The provision is effective on the date of enactment for bonds issued after December 31, 2006.

## I. Modification of Treatment of Loans to Qualified Continuing Care Facilities (sec. 209 of the Act and sec. 7872(g) of the Code)

### *Present Law*

Present law provides generally that certain loans that bear interest at a below-market rate are treated as loans bearing interest at the market rate, accompanied by imputed payments characterized in accordance with the substance of the transaction (for example, as a gift, compensation, a dividend, or interest).[303]

An exception to this imputation rule is provided for any calendar year for a below-market loan made by a lender to a qualified continuing care facility pursuant to a continuing care contract, if the lender or the lender's spouse attains age 65 before the close of the calendar year.[304]

The exception applies only to the extent the aggregate outstanding loans by the lender (and spouse) to any qualified continuing care facility do not exceed $163,300 (for 2006).[305]

For this purpose, a continuing care contract means a written contract between an individual and a qualified continuing care facility under which: (1) the individual or the individual's spouse may use a qualified continuing care facility for their life or lives; (2) the individual or the individual's spouse will first reside in a separate, independent living unit with additional facilities outside such unit for the providing of meals and other personal care and will not require long-term nursing care, and then will be provided long-term and skilled nursing care as the health of the individual or the individual's spouse requires; and (3) no additional substantial payment is required if the individual or the individual's spouse requires in-

[302] Sec. 144(a)(4)(G) as added by sec. 340(a) of the American Jobs Creation Act of 2004, Pub. L. No. 108–357 (2004).
[303] Sec. 7872.
[304] Sec. 7872(g).
[305] Rev. Rul. 2005–75, 2005–49 I.R.B. 1073.

creased personal care services or long-term and skilled nursing care.

For this purpose, a qualified continuing care facility means one or more facilities that are designed to provide services under continuing care contracts, and substantially all of the residents of which are covered by continuing care contracts. A facility is not treated as a qualified continuing care facility unless substantially all facilities that are used to provide services required to be provided under a continuing care contract are owned or operated by the borrower. For these purposes, a nursing home is not a qualified continuing care facility.

### *Explanation of Provision*[306]

The provision modifies the present-law exception under section 7872(g) relating to loans to continuing care facilities by eliminating the dollar cap on aggregate outstanding loans and making other modifications.

The provision provides an exception to the imputation rule of section 7872 for any calendar year for any below-market loan owed by a facility which on the last day of the year is a qualified continuing care facility, if the loan was made pursuant to a continuing care contract and if the lender or the lender's spouse attains age 62 before the close of the year.

For this purpose, a continuing care contract means a written contract between an individual and a qualified continuing care facility under which: (1) the individual or the individual's spouse may use a qualified continuing care facility for their life or lives; (2) the individual or the individual's spouse will be provided with housing, as appropriate for the health of such individual or individual's spouse, (i) in an independent living unit (which has additional available facilities outside such unit for the provision of meals and other personal care), and (ii) in an assisted living facility or a nursing facility, as is available in the continuing care facility; and (3) the individual or the individual's spouse will be provided assisted living or nursing care as the health of the individual or the individual's spouse requires, and as is available in the continuing care facility. The Secretary is required to issue guidance that limits the term "continuing care contract" to contracts that provide only facilities, care, and services described in the preceding sentence.

For purposes of the provision, a qualified continuing care facility means one or more facilities: (1) that are designed to provide services under continuing care contracts; (2) that include an independent living unit, plus an assisted living or nursing facility, or both; and (3) substantially all of the independent living unit residents of which are covered by continuing care contracts. For these purposes, a nursing home is not a qualified continuing care facility.

For purposes of defining the terms "continuing care contract" and "qualified continuing care facility" under the provision, the term "assisted living facility" is intended to mean a facility at which assistance is provided (1) with activities of daily living (such as eating, toileting, transferring, bathing, dressing, and continence) or (2)

[306] The provision was subsequently made permanent in Division A, section 425 of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109–432, described in Part Fourteen.

in cases of cognitive impairment, to protect the health or safety of an individual. The term "nursing facility" is intended to mean a facility that offers care requiring the utilization of licensed nursing staff.

The provision does not apply to any calendar year after 2010. Thus, the provision does not apply with respect to interest imputed after December 31, 2010. After such date, the law as in effect prior to enactment applies.

### *Effective Date*

The provision is generally effective for calendar years beginning after December 31, 2005, with respect to loans made before, on, or after such date.

## TITLE III—ALTERNATIVE MINIMUM TAX RELIEF

### A. Extend and Increase Alternative Minimum Tax Exemption Amount for Individuals (sec. 301 of the Act and sec. 55 of the Code)

#### *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 amounts are: (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 unmarried individuals other than surviving spouses; (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 estates and trusts. The exemption amounts are 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 unmarried individuals other than surviving spouses, and (3) $75,000 in the case of married individuals filing separate returns, estates, and trusts. These amounts are not indexed for inflation.

#### *Explanation of Provision*

Under the provision, for taxable years beginning in 2006, the exemption amounts are increased to: (1) $62,550 in the case of married individuals filing a joint return and surviving spouses; (2) $42,500 in the case of unmarried individuals other than surviving spouses; and (3) $31,275 in the case of married individuals filing a separate return.

#### *Effective Date*

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

## B. Allowance of Nonrefundable Personal Credits Against Regular and Alternative Minimum Tax Liability (sec. 302 of the Act and sec. 26 of the Code)

### *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).

For taxable years beginning in 2005, the nonrefundable personal 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 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 amounts are: (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.

### *Reasons for Change*

The Congress believes that the nonrefundable personal credits should be useable without limitation by reason of the alternative minimum tax.

### *Explanation of Provision*

The provision extends for one year the present-law provision allowing nonrefundable personal credits to the full extent of the individual's regular tax and alternative minimum tax (through taxable years beginning on or before December 31, 2006).

### *Effective Date*

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

## TITLE IV—CORPORATE ESTIMATED TAX PROVISIONS

### A. Modifications to Corporate Estimated Tax Payments (sec. 401 of the Act)

#### *Present Law*

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

#### *Explanation of Provision*

In case of a corporation with assets of at least $1 billion, payments due in July, August, and September, 2006, shall be increased to 105 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

In case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2012, shall be increased to 106.25 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

In case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2013, shall be increased to 100.75 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

With respect to corporate estimated tax payments due on September 15, 2010, 20.5 percent shall not be due until October 1, 2010.

With respect to corporate estimated tax payments due on September 15, 2011, 27.5 percent shall not be due until October 1, 2011.

#### *Effective Date*

The provision is effective on the date of enactment (May 17, 2006).

## TITLE V—REVENUE OFFSET PROVISIONS

### A. Application of Earnings Stripping Rules to Partners Which Are Corporations (sec. 501 of the Act and sec. 163 of the Code)

#### *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"),[307] 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.

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.[308] 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.[309] 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.[310]

#### *Explanation of Provision*

The provision 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 provi-

[307] This interest also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.
[308] Prop. Treas. Reg. sec. 1.163(j)–3(b)(3).
[309] Prop. Treas. Reg. sec. 1.163(j)–2(e)(4).
[310] Prop. Treas. Reg. sec. 1.163(j)–2(e)(5).

sion 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 provision 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 provision. 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 provision is effective for taxable years beginning on or after the date of enactment (May 17, 2006).

## B. Amend Information Reporting Requirements to Include Interest on Tax-Exempt Bonds (sec. 502 of the Act and sec. 6049 of the Code)

### *Present Law*

#### *Tax-exempt bonds*

Generally, gross income does not include interest on State or local bonds.[311] State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental facilities or the debt is repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (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 purposes ("qualified private activity bonds") permitted by the Code.[312]

#### *Tax-exempt interest reporting by taxpayers*

The Code provides that every person required to file a return must report the amount of tax-exempt interest received or accrued during any taxable year.[313] There are a number of reasons why the amount of tax-exempt interest received is relevant to determining tax liability despite the general exclusion from income. For example, the interest income from qualified private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986, is a preference item for purposes of calculating the alternative minimum tax ("AMT").[314] Tax-exempt interest also is relevant for determining eligibility for the earned income credit (the "EIC")[315]

[311] Sec. 103.
[312] Secs. 103(b)(1) and 141.
[313] Sec. 6012(d).
[314] Sec. 57(a)(5). Special rules apply to exclude refundings of bonds issued before August 8, 1986, and certain bonds issued before September 1, 1986.
[315] Sec. 32(i).

and the amount of Social Security benefits includable in gross income.[316] Moreover, determining includable Social Security benefits is necessary for calculating either adjusted or modified adjusted gross income under several Code sections.[317]

***Information reporting by payors***

The Code generally requires every person who makes payments of interest aggregating $10 or more or receives payments of interest as a nominee and who makes payments aggregating $10 or more to file an information return setting forth the amount of interest payments for the calendar year and the name, address, and TIN[318] of the person to whom interest is paid.[319] Treasury regulations prescribe the form and manner for filing interest payment information returns. Penalties are imposed for failures to file interest payment information returns or payee statements.[320] Treasury regulations also impose recordkeeping requirements on any person required to file information returns.[321] The Code excludes interest paid on tax-exempt bonds from interest reporting requirements.[322]

### *Explanation of Provision*

The provision eliminates the exception from information reporting requirements for interest paid on tax-exempt bonds.

### *Effective Date*

The provision is effective for interest paid on tax-exempt bonds after December 31, 2005.

## C. Amortization of Geological and Geophysical Expenditures (sec. 503 of the Act and sec. 167(h) of the Code)

### *Present Law*

Geological and geophysical expenditures ("G&G costs") are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals. G&G costs incurred in connection with oil and gas exploration in the United States may be amortized over two years.[323] In the case of abandoned property, remaining basis may not be recovered in the year of abandonment of a property as all basis is recovered over the two-year amortization period.

### *Explanation of Provision*

The provision extends the two-year amortization period for G&G costs to five years for certain major integrated oil companies. Under the provision, the five-year amortization rule for G&G costs

[316] Sec. 86.
[317] See Secs. 135, 219, and 221.
[318] The taxpayer's identification number, generally, for individuals is the taxpayer's social security number. Sec. 7701(a)(41).
[319] Sec. 6049.
[320] Secs. 6721 and 6722.
[321] Treas. Reg. sec. 1.6001–1(a).
[322] Sec. 6049.
[323] Sec. 167(h).

applies only to integrated oil companies that have an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year, gross receipts in excess of $1 billion in the last taxable year ending during calendar year 2005, and an ownership interest in a crude oil refiner of 15 percent or more.

### *Effective Date*

The provision applies to amounts paid or incurred after the date of enactment (May 17, 2006).

## D. Application of Foreign Investment in Real Property Tax Act ("FIRPTA") to Regulated Investment Companies ("RICs") (sec. 504 of the Act and sec. 897(h)(4) of the Code)

### *Present Law*

#### *In general*

A nonresident alien individual or foreign corporation is taxable on its taxable income which is effectively connected with the conduct of a trade or business within the United States, at the income tax rates applicable to U.S. persons. A nonresident alien individual is taxed (at a 30-percent rate) on gains, derived from sources within the United States, from the sale or exchange of capital assets if the individual is present in the United States for 183 days or more during the taxable year.

In addition, the Foreign Investment in Real Property Tax Act (FIRPTA)[324] generally treats a nonresident alien individual or foreign corporation's gain or loss from the disposition of a U.S. real property interest (USRPI) as income that is effectively connected with a U.S. trade or business, and thus taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. A foreign investor subject to tax on this income is required to file a U.S. income tax return under the normal rules relating to receipt of income effectively connected with a U.S. trade or business.

The payor of FIRPTA effectively connected income to a foreign person is generally required to withhold U.S. tax from the payment. Withholding is generally 10 percent of the sales price in the case of a direct sale by the foreign person of a USRPI, and 35 percent of the amount of a distribution to a foreign person of proceeds attributable to such sales from an entity such as a partnership.[325] The foreign person can request a refund with its U.S. tax return, if appropriate based on that person's total U.S. effectively connected income and deductions (if any) for the taxable year.

---

[324] FIRPTA is codified in section 897 of the Code.

[325] Sec. 1445 and Treasury regulations thereunder. The Treasury department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 15 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 15 percent.

Section 1445 statutorily requires the 10 percent withholding by the purchaser of a USRPI and the 35 percent withholding (or less if directed by Treasury) on certain distributions by partnerships, trusts, and estates, among other situations. Treasury regulations prescribe the 35 percent withholding requirement for distributions by REITs to foreign shareholders. Treas. Reg. sec. 1.1445–8. No regulations have been issued relating specifically to RIC distributions, which first became subject to FIRPTA in 2005.

USRPIs include interests in real property located in the United States or the U.S. Virgin Islands, and stock of a domestic U.S. real property holding company (USRPHC), generally defined as any corporation, unless the taxpayer established that the fair market value of its U.S. real property interests is less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and of all its assets used or held for use in a trade or business.[326] However, any class of stock that is regularly traded on an established securities market located in the U.S. is treated as a U.S. real property interest only if the seller held more than 5 percent of the stock at any time during the 5-year period ending on the date of disposition of the stock.[327]

***Special rules for certain investment entities***

Real estate investment trusts and regulated investment companies are generally passive investment entities. They are organized as U.S. domestic entities and are taxed as U.S. domestic corporations. However, because of their special status, they are entitled to deduct amounts distributed to shareholders and, in some cases, to allow the shareholders to characterize these amounts based on the type of income the REIT or RIC received. Among numerous other requirements for qualification as a REIT or RIC, the entity is required to distribute to shareholders at least 90 percent its income (excluding net capital gain) annually.[328] A REIT or RIC may designate a capital gain dividend to its shareholders, who then treat the amount designated as capital gain.[329] A REIT or RIC is taxed at regular corporate rates on undistributed income; but the combination of the requirement to distribute income other than net capital gain, plus the ability to declare a capital gain dividend and avoid corporate level tax on such income, can result in little, if any, corporate level tax paid by a REIT or RIC. Instead, the shareholder-level tax on distributions is the principal tax paid with respect to income of these entities. The requirements for REIT eligibility include primary investment in real estate assets (which assets can include mortgages). The requirements for RIC eligibility include primary investment in stocks and securities (which can include stock of REITs or of other RICs).

FIRPTA contains special rules for real estate investment trusts (REITs) and regulated investment companies (RICs).[330]

Stock of a "domestically controlled" REIT is not a USRPI. The term "domestically controlled" is defined to mean that less than 50 percent in value of the REIT has been owned by non-U.S. shareholders during the 5-year period ending on the date of disposition.[331] For 2005, 2006, and 2007, a similar exception applies to RIC stock. Thus, stock of a domestically controlled REIT or RIC can be sold without FIRPTA consequences. This exception applies regardless of whether the sale of stock is made directly by a foreign person, or by a REIT or RIC whose distributions to foreign persons

[326] Sec. 897(c)(2).
[327] Sec. 897(c)(3).
[328] Secs. 852(a)(1) and 852(b)(2)(A); 857(a)(1).
[329] Secs. 852(b)(3); 857(b)(3).
[330] Sec. 897(h).
[331] Sec. 897(h)(2) and (h)(4)(B).

of gain attributable to the sale of USRPI's would be subject to FIRPTA as described below.

A distribution by a REIT to a foreign shareholder, to the extent attributable to gain from the REIT's sale or exchange of USRPIs, is generally treated as FIRPTA gain to the shareholder. An exception enacted in 2004 applies if the distribution is made on a class of REIT stock that is regularly traded on an established securities market located in the United States and the foreign shareholder has not held more than 5 percent of the class of stock at any time during the one-year period ending on the date of the distribution.[332] Where the exception applies, the distribution to the foreign shareholder is treated as the distribution of an ordinary dividend (rather than as a capital gain dividend), subject to 30-percent (or lower treaty rate) withholding.[333]

Prior to 2005, distributions by RICs to foreign shareholders, to the extent attributable to the RIC's sale or exchange of USRPIs, were not treated as FIRPTA gain. If distributions were attributable to long-term capital gains, the RIC could designate the distributions as long-term capital gain dividends that would not be subject to any tax to the foreign shareholder, rather than as a regular dividends subject to 30-percent (or lower treaty rate) withholding.[334] For 2005, 2006, and 2007, RICs are subject to the rule that had applied to REITs prior to 2005, i.e., any distribution to a foreign shareholder attributable to gain from the RIC's sale of a USRPI is characterized as FIRPTA gain, without any exceptions.[335]

### *Explanation of Provision*

The provision provides that distributions by a RIC to foreign shareholders of amounts attributable to the sale of USRPIs are not treated as FIRPTA income unless the RIC itself is a U.S. real property holding corporation (i.e. 50 percent or more of its value is represented by its U.S. real property interests, including investments in U.S. real property holding corporations). In determining whether a RIC is a real property holding company for this purpose, a special rule applies that requires the RIC to include as U.S. real property interests its holdings of RIC or REIT stock if such RIC or REIT is a U.S. real property holding corporation, even if such stock is regularly traded on an established securities market and even if the RIC owns less than 5 percent of such stock. Another special rule requires the RIC to include as U.S. real property interests its interests in any domestically controlled RIC or REIT that is a U.S. real property holding corporation.

---

[332] This exception, effective beginning in 2005, was added by section 418 of the American Jobs Creation Act of 2004 ("AJCA"), Pub. L. No. 108–357, and modified by section 403(p) of the Tax Technical Corrections Act of 2005.

[333] Sec. 857(b)(3)(F).

[334] Sec. 852(b)(3)(C); Treas. Reg. sec. 1.1441–3(c)(2)(D).

[335] This requirement for RICs was added by section 411 of the American Jobs Creation Act of 2004 ("AJCA"), in connection with the enactment of other rules that allow RICs to identify certain types of distributions to foreign shareholders, attributable to the RIC's receipt of short-term capital gains or interest income, as distributions to such shareholders of such short-term gains or interest income and thus not taxed to the foreign shareholders, rather than as regular dividends that would be subject to withholding. See Secs. 871(k), 881(e), 1441(c)(12) and 1442(a). All these rules are scheduled to expire at the end of 2007, as is the rule subjecting to FIRPTA all distributions of RIC gain attributable to sales of U.S. real property interests and the rule excepting from FIRPTA a foreign person's sale of stock of a "domestically controlled" RIC.

### *Effective Date*

The provision takes effect as if included in the provisions of section 411 of the American Jobs Creation Act of 2004 to which it relates.

## E. Treatment of REIT and RIC Distributions Attributable to FIRPTA Gains (secs. 505 and 506 of the Act and secs. 897, 852, and 871 of the Code)

### *Present Law*

#### *General treatment of U.S.-source income of foreign investors*

*Fixed and determinable annual and periodical income*

The United States generally imposes a flat 30-percent tax, collected by withholding, on the gross amount of U.S.-source investment income payments, such as interest, dividends, rents, royalties and similar types of fixed and determinable annual and periodical income, to nonresident alien individuals and foreign corporations ("foreign persons").[336] Under treaties, the United States may reduce or eliminate such taxes.

*Dividends*

Even taking into account U.S. treaties, the tax on a dividend generally is not entirely eliminated. Instead, U.S.-source portfolio investment dividends received by foreign persons generally are subject to U.S. withholding tax at a rate of at least 15 percent.

*Interest*

Although payments of U.S.-source interest that is not effectively connected with a U.S. trade or business generally are subject to the 30-percent withholding tax, there are exceptions to that rule. For example, interest from certain deposits with banks and other financial institutions is exempt from tax.[337] Original issue discount on obligations maturing in 183 days or less from the date of original issue (without regard to the period held by the taxpayer) is also exempt from tax.[338] An additional exception is provided for certain interest paid on portfolio obligations.[339] Such "portfolio interest" generally is defined as any U.S.-source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (i) on an obligation that satisfies certain registration requirements or specified exceptions thereto (i.e., the obligation is "foreign targeted"), and (ii) that is not received by a 10-percent shareholder.[340] With respect to a registered obligation, a statement that the beneficial owner is not a U.S. person is required.[341] This exception is not available for any interest received either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), or by a controlled foreign corporation from a related per-

[336] Secs. 871(a), 881, 1441, and 1442.
[337] Secs. 871(i)(2)(A) and 881(d).
[338] Sec. 871(g).
[339] Secs. 871(h) and 881(c).
[340] Secs. 871(h)(3) and 881(c)(3).
[341] Secs. 871(h)(2), (5) and 881(c)(2).

son.[342] Moreover, this exception is not available for certain contingent interest payments.[343] For 2005, 2006 and 2007, a regulated investment company ("RIC") may designate certain distributions to foreign shareholders that are attributable to the RIC's qualified interest income as non-taxable interest distributions to such foreign persons.[344]

*Capital gains*

A foreign person generally is not subject to U.S. tax on capital gain, including gain realized on the disposition of stock or securities issued by a U.S. person, unless the gain is effectively connected with the conduct of a trade or business in the United States or such person is an individual present in the United States for a period or periods aggregating 183 days or more during the taxable year.[345] A regulated investment company (RIC) can generally designate dividends to foreign persons that are attributable to the RIC's long term capital gain as a long-term gain dividends that are not subject to withholding.[346] For 2005, 2006 and 2007, RICs may also designate short-term capital gain dividends.[347]

For the years 2005, 2006 and 2007, RIC capital gain dividends that are attributable to the sale of U.S. real property interests (which can include stock of companies that are U.S. real property holding companies) are subject to special rules described below.

Real estate investment trusts (REITs) can also designate long-term capital gain dividends to shareholders; but when made to a foreign person such distributions attributable to the sale of U.S. real property interests are also subject to the special rules described below.

***Foreign Investment in Real Property Tax Act ("FIRPTA")***

Unlike most other U.S. source capital gains, which are generally not taxed to a foreign investor, the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) subjects gain or loss of a foreign person from the disposition of a U.S. real property interest (USRPI) to tax as if the taxpayer were engaged in a trade or business within the United States and the gain or loss were effectively connected with such trade or business.[348] In addition to an interest in real property located in the United States or the Virgin Islands, USRPIs include (among other things) any interest in a domestic corporation unless the taxpayer establishes that the corporation was not, during a five-year period ending on the date of the disposition of the interest, a U.S. real property holding corporation (which is defined generally to mean any corporation the fair market value of whose U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of its real property interests and any other of its assets used or held for use in a trade or business).

---

[342] Sec. 881(c)(3).
[343] Secs. 871(h)(4) and 881(c)(4).
[344] This interest distribution rule was added by section 411 of the American Jobs Creation Act of 2004 ("AJCA"), Pub. L. No. 108–357.
[345] Secs. 871(a)(2) and 881.
[346] Treas. Reg. sec. 1.1441–3(c)(2)(D).
[347] This short-term gain distribution rule was added by section 411 of AJCA.
[348] Sec. 897.

Distributions by a REIT to its foreign shareholders attributable to the sale of USRPIs are generally treated as income from the sale of USRPIs.[349] Treasury regulations require the REIT to withhold at 35 percent on such a distribution.[350] However, there is an exception for distributions by a REIT with respect to stock of the REIT that is regularly traded on an established securities market located in the U.S., to a foreign shareholder that has not held more than 5 percent of the stock of the REIT for the one year period ending with the date of the distribution.[351] In such cases, the REIT and the shareholder treat the distribution to a foreign shareholder as the distribution of an ordinary dividend,[352] subject to the 30-percent (or lower treaty rate) withholding applicable to dividends.

For 2005, 2006, and 2007, any RIC distribution to a foreign shareholder attributable to the sale of USRPIs is treated as FIRPTA income, without any exceptions.[353] However, no Treasury regulations have been issued addressing withholding obligations with respect to such distributions.

A more complete description of the provisions of FIRPTA and the special rules under FIRPTA that apply to RICs and REITs is contained under "Present Law" for the provision "Application of Foreign Investors in Real Property Tax Act (FIRPTA) to Regulated Investment Companies (RICS)".

Although the law thus provides rules for taxing foreign persons under FIRPTA on distributions of gain from the sale of USRPIs by RICs or REITs, some taxpayers may be taking the position that if a foreign person invests in a RIC or REIT that, in turn, invests in a lower-tier RIC or REIT that is the entity that disposes of USRPIs and distributes the proceeds, then the proceeds from such disposition by the lower-tier RIC or REIT cease to be FIRPTA income when distributed to the upper-tier RIC or REIT (which is not itself a foreign person), and can thereafter be distributed by that latter entity to its foreign shareholders as non-FIRPTA income of such RIC or REIT, rather than continuing to be categorized as FIRPTA income. Furthermore, RICs may take the position that in the absence of regulations or a specific statutory rule addressing the withholding rules for FIRPTA capital gain that is treated as effectively connected with a U.S. trade or business, such gain should be considered capital gain for which no withholding is required.

In addition, some foreign persons may be attempting to avoid FIRPTA tax on a distribution from a RIC or a REIT, by selling the RIC or REIT stock shortly before the distribution and buying back the stock shortly after the distribution. If the stock is not a U.S. real property interest in the hands of the foreign seller, that person would take the position that the gain on the sale of the stock is capital gain not subject to U.S. tax. Stock of a RIC or REIT that is "domestically controlled" is not a U.S. real property interest.[354]

---

[349] Sec. 897(h)(1).

[350] Treas. Reg. sec. 1.1445–8.

[351] Sec. 897(h)(1)(second sentence).

[352] Sec. 857(b)(3)(F).

[353] Sec. 897(h)(1).

[354] Sec. 897(g)(3). A RIC or REIT is "domestically controlled" if less than 50 percent in value of the entity's stock is held by foreign persons. RIC stock ceases to be eligible for this exception as of the end of 2007. Distributions by a domestically controlled RIC or REIT, if attributable to the sale of U.S. real property interests, are not exempt from FIRPTA by reason of such domestic control. A foreign person that would be subject to FIRPTA on receipt of a distribution

If the stock is a USRPI in the hands of the foreign person, the transferee generally is required to withhold 10 percent of the gross sales price under general FIRPTA withholding rules.[355]

### *Explanation of Provision*

The first part of the provision requires any distribution that is made by a RIC or a REIT that would otherwise be subject to FIRPTA because the distribution is attributable to the disposition of a U.S. real property interest (USRPI) to retain its character as FIRPTA income when distributed to any other RIC or REIT, and to be treated as if it were from the disposition of a USRPI by that other RIC or REIT. Under the provision, a RIC continues to be subject to FIRPTA, even after December 31, 2007, in any case in which a REIT makes a distribution to the RIC that is attributable to gain from the sale of U.S. real property interests. The provision amends section 1445 so that it explicitly requires withholding on RIC and REIT distributions to foreign persons, attributable to the sale of USRPIs, at 35 percent, or, to the extent provided by regulations, at 15 percent.[356]

The provision also provides that a distribution by a RIC or REIT to a foreign shareholder attributable to sales of USRPIs is not treated as gain from the sale of a USRPI by that shareholder if the distribution is made with respect to a class of RIC stock that is regularly traded on an established securities market[357] located in the U.S. and if such shareholder did not hold more than 5 percent of such stock of within the one year period ending on the date of the distribution. Such distributions instead are treated as dividend distributions.[358]

---

from such an entity might sell its stock before the distribution and repurchase stock after the distribution in an attempt to avoid FIRPTA consequences.

Under a different exception from FIRPTA, applicable to stock of all entities, neither RIC nor REIT stock is a U.S. real property interest if the RIC or REIT stock is regularly traded on an established securities market located in the United States and if the stock sale is made by a foreign shareholder that has not owned more than five percent of the stock during the five years ending with the date of the sale. Sec. 897(c)(3). Distributions by a REIT to a foreign person, attributable to the sale of U.S. real property interests, are also not subject to FIRPTA if made with respect to stock that is regularly traded on an established securities market located in the United States and made to a foreign person that has not held more than five percent of the REIT stock for the one-year period ending on the date of distribution. (Sec. 897(h)(1), second sentence.) Thus, any foreign shareholder of such a regularly traded REIT that would be exempt from FIRPTA on a sale of the REIT stock immediately before a distribution would also generally be exempt from FIRPTA on a distribution from the REIT if such shareholder held the stock through the date of the distribution, due to the holding period requirements. Distributions that are not subject to FIRPTA under this five percent exception are recharacterized as ordinary dividends and thus would normally be subject to ordinary dividend withholding rules. Secs. 857(b)(3)(F) and 1441.

[355] Secs. 1445(a) and 1445(e).

[356] This provision is similar to present law section 1445(c)(1). The regulatory authority to reduce the withholding to 15 percent sunsets in accordance with the same sunset that applies to section 1445(c)(1), at the time that the present law maximum 15 percent rate on dividends is scheduled to sunset.

Treasury regulations under section 1445 already impose FIRPTA withholding on REITs under present law. Treasury has not yet written regulations applicable to RICs. No inference is intended regarding the existing Treasury regulations in force under section 1445 with respect to REITs.

[357] It is intended that the rules generally applicable for this purpose under section 897 also apply under the provision in determining whether a class of interests is regularly traded on an established securities market located in the United States. For example, at the present time the rules currently in force for this purpose include Temp. Reg. sec. 1.897–9T(d)(2).

[358] The provision treats such distributions as ordinary dividend distributions rather than as distributions of long term capital gain. This rule is the same as the present law rule for publicly traded REITs making a distribution to a foreign shareholder. In addition, under the imme-

Continued

If the distribution is not to a foreign shareholder but to a RIC or REIT, the character of the distribution as FIRPTA gain is retained and must be tracked by the recipient RIC or REIT, but the distribution itself does not become dividend income in the hands of such RIC or REIT. Therefore, such recipient RIC or REIT can in turn distribute amounts attributable to that distribution (attributable to the sale of USRPIs) to its U.S shareholders as capital gain. However, if any recipient RIC or REIT in turn distributes to a foreign shareholder amounts that are attributable to a sale by a lower tier RIC or REIT of USRPIs, such amounts distributed to a foreign shareholder shall be treated as FIRPTA gain or as dividend income, according to whether or not such distribution to such foreign shareholder qualifies for dividend treatment.

The second part of the provision requires a foreign person that disposes of stock of a RIC or REIT during the 30-day period preceding the ex-dividend date of a distribution on that stock that would have been treated as a distribution from the disposition of a USRPI, that acquires a substantially identical stock interest during the 61-day period beginning the first day of such 30-day period,[359] and that does not in fact receive the distribution in a manner that subjects the person to tax under FIRPTA, to pay FIRPTA tax on an amount equal to the amount of the distribution that was not taxed under FIRPTA as a result of the disposition. Treatment of a foreign shareholder of a RIC or REIT as if it had received a FIRPTA distribution that is treated as U.S. effectively connected income also is extended to transactions that meet the definition of "substitute dividend payments" provided for purposes of section 861 and that would be properly treated by the foreign taxpayer as receipt of a distribution of FIRPTA gain if the distribution from the RIC or REIT had itself been received by the taxpayer, but that, by virtue of the substitute dividend payment, is not so treated but for the provision,[360] as well as to other similar arrangements to which Treasury may extend the rules.

A foreign person is treated as having acquired any interest acquired by any person treated as related to that foreign person

---

diately preceding provision, for the years 2005, 2006 and 2007 that RICs are subject to FIRPTA, a RIC can make distributions from sales of USRPIs to shareholders who do not meet this rule, and such distributions will be treated not as dividends but as non-taxable long- or short-term capital gain, if so designated by the RIC, as long as the RIC itself is not a USRPHC after applying the special rules for counting the RIC's ownership of REIT or other RIC stock.

[359] Thus, the 61-day period includes the 30 days before and the 30 days after the ex-dividend date, in addition to the ex-dividend date itself.

[360] The provision adopts the definition of "substitute dividend payment" used for purposes of section 861, which definition applies to determine substitute dividend payments under the provision, even though the recipient may not be an individual and even though the underlying payment would not have been treated as a dividend to the recipient but as a distribution of FIRPTA gain. Treasury regulations section 1.861–3(a)(6) defines a "substitute dividend payment" as a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction. The regulation applies to amounts received or accrued by the taxpayer. The regulation defines a securities lending transaction as a transfer of one or more securities that is described in section 1058(a) or a substantially similar transaction. The regulation defines a sale-repurchase transaction as an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive substantially identical securities from the transferee in the future in exchange for cash. Under the regulation, a "substitute dividend payment" is generally sourced and in many instances characterized in the same manner as the underlying distribution with respect to the transferred security.

under section 267(b) or (707(b)(1)(C).[361] For purposes of this new "wash sale" rule, the treatment of a RIC as a "qualified investment entity" continues even after December 31, 2007.

This "wash sale" part of the provision applies only in the case of a shareholder that would have been treated as receiving FIRPTA income on the distribution if that shareholder had in fact received the distribution, but that would not have been treated as receiving FIRPTA income if the form of the disposition transaction were respected. This category of persons consists of persons that are shareholders in a domestically controlled RIC or REIT (since sales of shares of such an entity are not subject to FIRPTA tax), but does not include a person who sells stock that is regularly traded on an established securities market located in the U.S. and who did not own more than five percent of such stock during the one year period ending on the date of the distribution (since such a person would not have been subject to FIRPTA tax under present and prior law for REITs and under the provision for RICs, supra., if that person had received the dividend instead of disposing of the stock).

Notwithstanding the recharacterization of the disposition as involving a FIRPTA distribution to the foreign person, no withholding on disposition proceeds to the foreign person on the disposition of such stock would be required. No inference is intended as to what situations under present law would or would not be respected as dispositions.

### *Effective Date*

The first part of the provision, relating to distributions generally, applies to distributions with respect to taxable years of RICs and REITs beginning after December 31, 2005, except that no withholding is required under sections 1441, 1442, or 1445 with respect to any distribution before May 17, 2006 (the date of enactment) if such amount was not otherwise required to be withheld under any such section as in effect before the changes made by the provision.

The second part of the provision, relating to the "wash sale" and substitute dividend payment transactions, is applicable to distributions and substitute dividend payments occurring on or after June 16, 2006 (the 30th day following May 17, 2006, the date of enactment).

No inference is intended regarding the treatment under present law of any transactions addressed by the provision.

## F. 355 Distributions Involving Disqualified Investment Companies (sec. 507 of the Act and sec. 355 of the Code)

A description of this section is included in the description of section 202 of the Act at Title II B.

[361] These relationships generally include persons that are engaged in trades or businesses under common control (generally, a more than 50 percent relationship).

## G. Impose Loan and Redemption Requirements on Pooled Financing Bonds (sec. 508 of the Act and sec. 149 of the Code)

### *Present Law*

#### *In general*

Interest on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes if the proceeds of such bonds are used to finance direct activities of governmental units or if such bonds are repaid with revenues of governmental units. These bonds are called "governmental bonds." Interest on State or local government bonds issued to finance activities of private persons is taxable unless a specific exception applies. These bonds are called "private activity bonds." The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes. In addition, the Code imposes qualification requirements that apply to all State and local bonds. Arbitrage restrictions, for example, limit the ability of issuers to profit from investment of tax-exempt bond proceeds. The Code also imposes requirements that only apply to specific types of bond issues. For instance, pooled financing bonds (defined below) are not tax-exempt unless the issuer meets certain requirements regarding the expected use of proceeds.

#### *Pooled financing bond restrictions*

State or local governments also issue bonds to provide financing for the benefit of a third party (a "conduit borrower"). Pooled financing bonds are bond issues that are used to make or finance loans to two or more conduit borrowers, unless the conduit loans are to be used to finance a single project.[362] The Code imposes several requirements on pooled financing bonds if more than $5 million of proceeds are expected to be used to make loans to conduit borrowers. For purposes of these rules, a pooled financing bond does not include certain private activity bonds.[363]

A pooled financing bond is not tax-exempt unless the issuer reasonably expects that at least 95 percent of the net proceeds will be lent to ultimate borrowers by the end of the third year after the date of issue. The term "net proceeds" is defined to mean the proceeds of the issue less the following amounts: (1) proceeds used to finance issuance costs; (2) proceeds necessary to pay interest on the bonds during a three-year period; and (3) amounts in reasonably required reserves.[364]

An issuer's past experience regarding loan origination is a criterion upon which the reasonableness of the issuer's expectations can be based. As an additional requirement for tax exemption, all legal and underwriting costs associated with the issuance of pooled financing bonds may not be contingent and must be substantially paid within 180 days of the date of issuance.

---

[362] Treas. Reg. sec. 1.150–1(b).
[363] Sec. 149(f)(4)(B).
[364] Sec. 149(f)(2)(C).

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

To prevent the issuance of more Federally subsidized tax-exempt bonds than necessary; the tax exemption for State and local bonds does not apply to any arbitrage bond.[365] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments. In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government ("arbitrage rebate").

The Code contains several exceptions to the arbitrage rebate requirement, including an exception for bonds issued by small governments (the "small issuer exception"). For this purpose, small governments are defined as general purpose governmental units that issue no more than $5 million of tax-exempt governmental bonds in a calendar year.[366]

Pooled financing bonds are subject to the arbitrage restrictions that apply to all tax-exempt bonds, including arbitrage rebate. Under certain circumstances, however, small governments may issue pooled financing bonds without those bonds counting towards the determination of whether the issuer qualifies for the small issuer exception to arbitrage rebate. In the case of a pooled financing bond where the ultimate borrowers are governmental units with general taxing powers not subordinate to the issuer of the pooled bond, the pooled bond does not count against the issuer's $5 million limitation, provided the issuer is not a borrower from the pooled bond.[367] However, the issuer of the pooled financing bond remains subject to the arbitrage rebate requirement for unloaned proceeds.[368]

## *Explanation of Provision*

### *In general*

The provision imposes new requirements on pooled financing bonds as a condition of tax-exemption. First, the provision imposes a written loan commitment requirement to restrict the issuance of pooled bonds where potential borrowers have not been identified ("blind pools"). Second, in addition to the current three-year expectations requirement, the issuer must reasonably expect that at least 30 percent of the net proceeds of the pooled bond will be loaned to ultimate borrowers one year after the date of issue. Third, the provision requires the redemption of outstanding bonds with proceeds that are not loaned to ultimate borrowers within the required loan origination periods. Finally, the provision eliminates

[365] Secs. 103(a) and (b)(2).

[366] The $5 million limit is increased to $15 million if at least $10 million of the bonds are used to finance public schools.

[367] Sec. 148(f)(4)(D)(ii)(II).

[368] Treas. Reg. sec. 1.148–8(d)(1).

the rule allowing an issuer of pooled financing bonds to disregard the pooled bonds for purposes of determining whether the issuer qualifies for the small issuer exception to rebate.

***Borrower identification***

Under the provision, interest on a pooled financing bond is tax exempt only if the issuer obtains written commitments with ultimate borrowers for loans equal to at least 30 percent of the net proceeds of the pooled bond prior to issuance. The loan commitment requirement does not apply to pooled financing bonds issued by (i) States (or an integral part of a State) to provide loans to subordinate governmental units or (ii) State entities created to provide financing for water-infrastructure projects through the federally-sponsored State revolving fund program.

***Loan origination expectations***

The provision imposes new reasonable expectations requirements for loan originations. The issuer must expect that at least 30 percent of the net proceeds of a pooled financing bond will be loaned to ultimate borrowers one year after the date of issue. This is in addition to the present-law requirement that at least 95 percent of the net proceeds will be loaned by the end of the third year after the date of issue. Bond proceeds that are not loaned to borrowers as required under the one- and three-year rules must be used to redeem outstanding bonds within 90 days of the expiration of such one- and three-year periods.

***Redemption requirement***

Under the provision, if pooled financing bond proceeds are not loaned to borrowers within prescribed periods, outstanding bonds equal to the amount of proceeds that were not loaned within the required period must be redeemed within 90 days of the expiration of the relevant loan origination period, i.e., either the one- or three-year period. For example, if one year after the date of issue only 25 percent of the net proceeds of such issue have been used to make loans to ultimate borrowers, an amount equal to five percent of the net proceeds of the issue is no longer available to make loans and must be used to redeem bonds within the following six-month period. Similarly, if only 85 percent of the net proceeds of an issue are used to make qualifying loans (or to redeem bonds) on the date that is three years after the date the bonds are issued, 10 percent of the remaining net proceeds must be used to redeem bonds within the following six months.

***Small issuer exception***

The provision eliminates the rule disregarding pooled financing bonds from the issuer's $5,000,000 annual limitation for purposes of the small issuer exception to arbitrage rebate.

### *Effective Date*

The provision is effective for bonds issued after the date of enactment (May 17, 2006).

## H. Partial Payments Required With Submissions of Offers-in-Compromise (sec. 509 of the Act and sec. 7122 of the Code)

### *Present Law*

The IRS has the authority to compromise any civil or criminal case arising under the internal revenue laws.[369] 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.[370] 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[371] 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.

### *Explanation of Provision*

The provision 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 provision, a lump-sum offer includes single payments as well as payments made in five or fewer installments. For periodic payment offers, the provision 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 may be returned to the taxpayer as unprocessable and immediate enforcement action is permitted. Any user fee imposed by the IRS for participation in the offer-in-compromise program must be submitted with the appropriate partial payment. The user fee is applied to the taxpayer's outstanding tax liability.

The provision 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.

The provision authorizes the Secretary to issue regulations providing exceptions to the partial payment requirements in the case

---

[369] Sec. 7122.

[370] *Olsen* v. *United States,* 326 F. Supp. 2d 184 (D. Mass. 2004).

[371] The IRS categorizes payment plans with more specificity, which is generally not significant for purposes of the provision. See Form 656, Offer-in-Compromise, page 6 of instruction booklet (revised July 2004).

of offers from certain low-income taxpayers and offers based on doubt as to liability.

### *Effective Date*

The provision is effective for offers-in-compromise submitted on and after the date which is 60 days after the date of enactment (May 17, 2006).

## I. Increase in Age of Minor Children Whose Unearned Income Is Taxed as if Parent's Income (sec. 510 of the Act and sec. 1(g) of the Code)

### *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 $5,150 (for 2006); (2) unearned income only over the minimum standard deduction amount for dependents ($850 in 2006); or (3) both earned income and unearned income totaling more than the smaller of (a) $5,150 (for 2006) or (b) the larger of (i) $850 (for 2006), or (ii) earned income plus $300.[372] Thus, if a dependent child has less than $850 in gross income, the child does not have to file an individual income tax return for 2006.[373]

A child who cannot be claimed as a dependent on another person's tax return is subject to the generally applicable filing requirements. Such a child generally must file a return if the individual's gross income exceeds the sum of the standard deduction and the personal exemption amount ($3,300 for 2006).

#### *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.[374] 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 $1,700 (for 2006); 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.[375] For children under age 14, net unearned income (for 2006, generally unearned income over $1,700) is taxed at the parent's rate if the par-

---

[372] 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).

[373] 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 2006, the standard deduction amount for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of $850 or the sum of $300 and the individual's earned income.

[374] Sec. 1(g).

[375] Sec. 1(g)(4) and sec. 911(d)(2).

ent'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 $1,700 (for 2006), 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.[376]

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 ($850 for 2006), and (2) the 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.[377] 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 the child has net capital gains or qualified dividends, these items are allocated to the parent's hypothetical taxable income according to the ratio of net unearned income to the child's total unearned 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.[378]

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.[379] In this case, items on the parent's

[376] Sec. 1(h).
[377] Sec. 1(g)(4).
[378] Sec. 1(g)(5); Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 6 (2005).
[379] The child must attach to the return Form 8615, Tax for Children Under Age 14 With Investment Income of More Than $1,700 (2006).

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 and unearned income up to $1,700 (for 2006), 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, 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);[380]

2. such income is more than the minimum standard deduction amount for dependents ($850 in 2006) and less than 10 times that amount ($8500 in 2006);

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 $1,700 for 2007). This amount is taxed at the parent's rate. The parent also must report an additional tax liability equal to the lesser of: (1) $85 (in 2006), or (2) 10 percent of the child's gross income exceeding the child's standard deduction ($850 in 2006).

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.[381] In addition, certain deductions that the child would have been entitled to take on his or her own return are lost.[382] 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.[383]

---

[380] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 6 (2005).

[381] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 7 (2005).

[382] Internal Revenue Service, Publication 929, Tax *Rules for Children and Dependents,* at 7 (2005).

[383] Sec. 1(g)(7)(B).

***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).[384] If the child's income tax is not paid, however, an assessment against 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.[385]

### *Explanation of Provision*

The provision increases the age to which the kiddie tax provisions apply from under 14 to under 18 years of age. The provision also creates 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. The provision provides that the kiddie tax does not apply to a child who is married and files a joint return for the taxable year

### *Effective Date*

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

## J. Imposition of Withholding on Certain Payments Made by Government Entities (sec. 511 of the Act and sec. 3402 of the Code)

### *Present Law*

***Withholding requirements***

Employers are required to withhold income tax on wages paid to employees, including wages and salaries of employees or elected officials of Federal, State, and local government units. Withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee.

Certain non-wage payments also are subject to mandatory or voluntary withholding. For example:

Employers are required to withhold FICA and Railroad Retirement taxes from wages paid to their employees. Withholding rates are generally uniform.

Payors of pensions are required to withhold from payments made to payees, unless the payee elects no withholding.[386] Withholding from periodic payments is at variable rates, parallel to income tax withholding from wages, whereas withholding from nonperiodic payments is at a flat 10-percent rate.

A variety of payments (such as interest and dividends) are subject to backup withholding if the payee has not provided a valid taxpayer identification number (TIN). Withholding is at a flat rate

[384] Sec. 73(a).
[385] Sec. 6201(c).
[386] Withholding at a rate of 20 percent is required in the case of an eligible rollover distribution that is not directly rolled over.

based on the fourth lowest rate of tax applicable to single taxpayers.

Certain gambling proceeds are subject to withholding. Withholding is at a flat rate based on the third lowest rate of tax applicable to single taxpayers.

Voluntary withholding applies to certain Federal payments, such as Social Security payments. Withholding is at rates specified by Treasury regulations.

Voluntary withholding applies to unemployment compensation benefits. Withholding is at a flat 10-percent rate.

Foreign taxpayers are generally subject to withholding on certain U.S.-source income which is not effectively connected with the conduct of a U.S. trade or business. Withholding is at a flat 30-percent rate (14-percent for certain items of income).

Many payments, including payments made by government entities, are not subject to withholding under present law. For example, no tax is generally withheld from payments made to workers who are not classified as employees (i.e., independent contractors).

### *Information reporting*

Present law imposes numerous information reporting requirements that enable the Internal Revenue Service ("IRS") to verify the correctness of taxpayers' returns. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of $600 or more made in the course of the payor's trade or business. Special information reporting requirements exist for employers required to deduct and withhold tax from employees' income. In addition, any service recipient engaged in a trade or business and paying for services is required to make a return according to regulations when the aggregate of payments is $600 or more. Government entities are specifically required to make an information return, reporting certain payments to corporations as well as individuals. Moreover, the head of every Federal executive agency that enters into certain contracts must file an information return reporting the contractor's name, address, TIN, date of contract action, amount to be paid to the contractor, and any other information required by Forms 8596 (Information Return for Federal Contracts) and 8596A (Quarterly Transmittal of Information Returns for Federal Contracts).

## *Explanation of Provision*

The provision requires withholding on certain payments to persons providing property or services made by the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies). The withholding requirement applies regardless of whether the government entity making such payment is the recipient of the property or services. Political subdivisions of States (or any instrumentality thereof) with less than $100 million of annual expenditures for property or services that would otherwise be subject to withholding under this provision are exempt from the withholding requirement.

The rate of withholding is three percent on all payments regardless of whether the payments are for property or services. Pay-

ments subject to withholding under the provision include any payment made in connection with a government voucher or certificate program which functions as a payment for property or services. For example, payments to a commodity producer under a government commodity support program are subject to the withholding requirement. The provision imposes information reporting requirements on the payments that are subject to withholding under the provision.

The provision does not apply to any payments made through a Federal, State, or local government public assistance or public welfare program for which eligibility is determined by a needs or income test. For example, payments under government programs providing food vouchers or medical assistance to low-income individuals are not subject to withholding under the provision. However, payments under government programs to provide health care or other services that are not based on the needs or income of the recipients are subject to withholding, including programs where eligibility is based on the age of the beneficiary.

The provision does not apply to payments of wages or to any other payment with respect to which mandatory (e.g., U.S.-source income of foreign taxpayers) or voluntary (e.g., unemployment benefits) withholding applies under present law. The provision does not exclude payments that are potentially subject to backup withholding under section 3406. If, however, payments are actually being withheld under backup withholding, withholding under the provision does not apply.

The provision also does not apply to the following: payments of interest; payments for real property; payments to tax-exempt entities or foreign governments; intra-governmental payments; payments made pursuant to a classified or confidential contract (as defined in section 6050M(e)(3)); and payments to government employees that are not otherwise excludable from the new withholding provision with respect to the employees' services as an employees.

### *Effective Date*

The provision applies to payments made after December 31, 2010.

## K. Eliminate Income Limitations on Roth IRA Conversions (sec. 512 of the Act and sec. 408A of the Code)

### *Present Law*

There are two general types of individual retirement arrangements ("IRAs"): traditional IRAs and Roth IRAs. The total amount that an individual may contribute to one or more IRAs for a year is generally limited to the lesser of: (1) a dollar amount ($4,000 for 2006); and (2) the amount of the individual's compensation that is includible in gross income for the year. In the case of an individual who has attained age 50 before the end of the year, the dollar amount is increased by an additional amount ($1,000 for 2006). In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses that is includible in gross income is at least equal to the

contributed amount. IRA contributions in excess of the applicable limit are generally subject to an excise tax of six percent per year until withdrawn.

Contributions to a traditional IRA may or may not be deductible. The extent to which contributions to a traditional IRA are deductible depends on whether or not the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan and the taxpayer's AGI. An individual may deduct his or her contributions to a traditional IRA if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual or the individual's spouse is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with AGI over certain levels. To the extent an individual does not or cannot make deductible contributions, the individual may make nondeductible contributions to a traditional IRA, subject to the maximum contribution limit. Distributions from a traditional IRA are includible in gross income to the extent not attributable to a return of nondeductible contributions.

Individuals with adjusted gross income ("AGI") below certain levels may make contributions to a Roth IRA (up to the maximum IRA contribution limit). The maximum Roth IRA contribution is phased out between $150,000 to $160,000 of AGI in the case of married taxpayers filing a joint return and between $95,000 to $105,000 in the case of all other returns (except a separate return of a married individual).[387] Contributions to a Roth IRA are not deductible. Qualified distributions from a Roth IRA are excludable from gross income. Distributions from a Roth IRA that are not qualified distributions are includible in gross income to the extent attributable to earnings. In general, a qualified distribution is a distribution that is made on or after the individual attains age 59½, death, or disability or which is a qualified special purpose distribution. A distribution is not a qualified distribution if it is made within the five-taxable year period beginning with the taxable year for which an individual first made a contribution to a Roth IRA.

A taxpayer with AGI of $100,000 or less may convert all or a portion of a traditional IRA to a Roth IRA.[388] The amount converted is treated as a distribution from the traditional IRA for income tax purposes, except that the 10-percent additional tax on early withdrawals does not apply.

In the case of a distribution from a Roth IRA that is not a qualified distribution, certain ordering rules apply in determining the amount of the distribution that is includible in income. For this purpose, a distribution that is not a qualified distribution is treated as made in the following order: (1) regular Roth IRA contributions; (2) conversion contributions (on a first in, first out basis); and (3) earnings. To the extent a distribution is treated as made from a conversion contribution, it is treated as made first from the portion,

[387] In the case of a married taxpayer filing a separate return, the phaseout range is $0 to $10,000 of AGI.

[388] Married taxpayers filing a separate return may not convert amounts in a traditional IRA into a Roth IRA.

if any, of the conversion contribution that was required to be included in income as a result of the conversion.

Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59½, death, or disability are subject to an additional 10-percent early withdrawal tax, unless an exception applies.

### *Explanation of Provision*

The provision eliminates the income limits on conversions of traditional IRAs to Roth IRAs.[389] Thus, taxpayers may make such conversions without regard to their AGI.

For conversions occurring in 2010, unless a taxpayer elects otherwise, the amount includible in gross income as a result of the conversion is included ratably in 2011 and 2012. That is, unless a taxpayer elects otherwise, none of the amount includible in gross income as a result of a conversion occurring in 2010 is included in income in 2010, and half of the income resulting from the conversion is includible in gross income in 2011 and half in 2012. However, income inclusion is accelerated if converted amounts are distributed before 2012.[390] In that case, the amount included in income in the year of the distribution is increased by the amount distributed, and the amount included in income in 2012 (or 2011 and 2012 in the case of a distribution in 2010) is the lesser of: (1) half of the amount includible in income as a result of the conversion; and (2) the remaining portion of such amount not already included in income. The following example illustrates the application of the accelerated inclusion rule.

*Example.*—Taxpayer A has a traditional IRA with a value of $100, consisting of deductible contributions and earnings. A does not have a Roth IRA. A converts the traditional IRA to a Roth IRA in 2010, and, as a result of the conversion, $100 is includible in gross income. Unless A elects otherwise, $50 of the income resulting from the conversion is included in income in 2011 and $50 in 2012. Later in 2010, A takes a $20 distribution, which is not a qualified distribution and all of which, under the ordering rules, is attributable to amounts includible in gross income as a result of the conversion. Under the accelerated inclusion rule, $20 is included in income in 2010. The amount included in income in 2011 is the lesser of (1) $50 (half of the income resulting from the conversion) or (2) $70 (the remaining income from the conversion), or $50. The amount included in income in 2012 is the lesser of (1) $50 (half of the income resulting from the conversion) or (2) $30 (the remaining income from the conversion, i.e., $100–$70 ($20 included in income in 2010 and $50 included in income in 2011)), or $30.

### *Effective Date*

The provision is effective for taxable years beginning after December 31, 2009.

---

[389] Under the provision, married taxpayers filing a separate return may convert amounts in a traditional IRA into a Roth IRA.

[390] Whether a distribution consists of converted amounts is determined under the present-law ordering rules.

## L. Repeal of FSC/ETI Binding Contract Relief (sec. 513 of the Act)

### *Present Law*[391]

For most of the last two decades, the United States provided export-related tax benefits under the foreign sales corporation ("FSC") regime. In 2000, the World Trade Organization ("WTO") held that the FSC regime constituted a prohibited export subsidy under the relevant trade agreements. In response to this WTO finding, the United States repealed the FSC rules and enacted a new regime, under the FSC Repeal and Extraterritorial Income ("ETI") Exclusion Act of 2000. Transition rules delayed the repeal of the FSC rules and the effective date of ETI for transactions in the ordinary course of a trade or business occurring before January 1, 2002, or after December 31, 2001 pursuant to a binding contract between the taxpayer and an unrelated person which was in effect on September 30, 2000 and at all times thereafter (the "FSC binding contract relief").[392] In 2002, the WTO held that the ETI regime also constituted a prohibited export subsidy.

In general, under the ETI regime, an exclusion from gross income applied with respect to "extraterritorial income," which was a taxpayer's gross income attributable to "foreign trading gross receipts." This income was eligible for the exclusion to the extent that it was "qualifying foreign trade income." Qualifying foreign trade income was the amount of gross income that, if excluded, would result in a reduction of taxable income by the greatest of: (1) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transaction; (2) 15 percent of the "foreign trade income" derived by the taxpayer from the transaction;[393] or (3) 30 percent of the "foreign sale and leasing income" derived by the taxpayer from the transaction.[394]

Foreign trading gross receipts were gross receipts derived from certain activities in connection with "qualifying foreign trade property" with respect to which certain economic processes had taken place outside of the United States. Specifically, the gross receipts must have been: (1) from the sale, exchange, or other disposition of qualifying foreign trade property; (2) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States; (3) for services which were related and subsidiary to the sale, exchange, disposition, lease, or rental of qualifying foreign trade property (as described above); (4) for engineering or architectural services for construction projects located outside the United States; or (5) for the performance of certain managerial

---

[391] This section includes a description of the law in effect before the repeal of the general ETI rules applicable before the American Jobs Creation Act of 2004 as well as the law in effect immediately prior to enactment of the provision below.

[392] An election was provided, however, under which taxpayers could adopt ETI at an earlier date for transactions after September 30, 2000. This election allowed the ETI rules to apply to transactions after September 30, 2000, including transactions occurring pursuant to pre-existing binding contracts.

[393] "Foreign trade income" was the taxable income of the taxpayer (determined without regard to the exclusion of qualifying foreign trade income) attributable to foreign trading gross receipts.

[394] "Foreign sale and leasing income" was the amount of the taxpayer's foreign trade income (with respect to a transaction) that was properly allocable to activities constituting foreign economic processes. Foreign sale and leasing income also included foreign trade income derived by the taxpayer in connection with the lease or rental of qualifying foreign trade property for use by the lessee outside the United States.

services for unrelated persons. A taxpayer could elect to treat gross receipts from a transaction as not being foreign trading gross receipts. As a result of such an election, a taxpayer could use any related foreign tax credits in lieu of the exclusion.

Qualifying foreign trade property generally was property manufactured, produced, grown, or extracted within or outside the United States that was held primarily for sale, lease, or rental in the ordinary course of a trade or business for direct use, consumption, or disposition outside the United States. No more than 50 percent of the fair market value of such property could be attributable to the sum of: (1) the fair market value of articles manufactured outside the United States; and (2) the direct costs of labor performed outside the United States. With respect to property that was manufactured outside the United States, certain rules were provided to ensure consistent U.S. tax treatment with respect to manufacturers.

The American Jobs Creation Act of 2004 ("AJCA") repealed the ETI exclusion,[395] generally effective for transactions after December 31, 2004. AJCA provides a general transition rule under which taxpayers retain 100 percent of their ETI benefits for transactions prior to 2005, 80 percent of their otherwise-applicable ETI benefits for transactions during 2005, and 60 percent of their otherwise-applicable ETI benefits for transactions during 2006.

In addition to the general transition rule, AJCA provides that the ETI exclusion provisions remain in effect for transactions in the ordinary course of a trade or business if such transactions are pursuant to a binding contract[396] between the taxpayer and an unrelated person and such contract is in effect on September 17, 2003, and at all times thereafter (the "ETI binding contract relief").

In early 2006, the WTO Appellate Body held that the ETI general transition rule and the FSC and ETI binding contract relief measures are prohibited export subsidies.

### *Explanation of Provision*

The provision repeals both the FSC binding contract relief and the ETI binding contract relief. The general transition rule remains in effect.

### *Effective Date*

The provision is effective for taxable years beginning after date of enactment (May 17, 2006).

---

[395] Pub. L. No. 108–357, sec. 101. In addition, foreign corporations that elected to be treated for all Federal tax purposes as domestic corporations in order to facilitate the claiming of ETI benefits were allowed to revoke such elections within one year of the date of enactment of the repeal without recognition of gain or loss, subject to anti-abuse rules.

[396] This rule also applies to a purchase option, renewal option, or replacement option that is included in such contract. For this purpose, a replacement option is considered enforceable against a lessor notwithstanding the fact that a lessor retained approval of the replacement lessee.

## M. Modification of Wage Limit for Purposes of Domestic Production Activities Deduction (sec. 514 of the Act and sec. 199 of the Code)

### *Present Law*

#### *In general*

Present law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's qualified production activities income. For taxable years beginning after 2009, the deduction is nine percent of such income. For taxable years beginning in 2005 and 2006, the deduction is three percent of income and, for taxable years beginning in 2007, 2008 and 2009, the deduction is six percent of income. However, the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer during the calendar year that ends in such taxable year.[397]

#### *Qualified production activities income*

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

#### *Application of wage limitation to passthrough entities*

For purposes of applying the wage limitation, a shareholder, partner, or similar person who is allocated components of qualified production activities income from a passthrough entity also is treated as having been allocated wages from such entity in an amount that is equal to the lesser of: (1) such person's allocable share of wages, as determined under regulations prescribed by the Secretary; or (2) twice the qualified production activities income that actually is allocated to such person for the taxable year.

### *Explanation of Provision*

Under the provision, the wage limitation is modified such that taxpayers may only include amounts which are properly allocable to domestic production gross receipts.[398] Thus, the wage limitation is 50 percent of those wages which are deducted in arriving at qualified production activities income.

In addition, the provision repeals the special limitation on wages treated as allocated to partners or shareholders of passthrough entities. Accordingly, for purposes of the wage limitation, a shareholder, partner, or similar person who is allocated components of qualified production activities income from a passthrough entity is treated as having been allocated wages from such entity in an

---

[397] For purposes of the provision, "wages" include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and, for taxable years beginning after December 31, 2005, designated Roth contributions (as defined in section 402A).

[398] As under present law, the Secretary shall provide rules for the proper allocation of items (including wages) in determining qualified production activities income. Section 199(c)(2).

amount that is equal to such person's allocable share of wages as determined under regulations prescribed by the Secretary, even if such amount is more than twice the qualified production activities income that actually is allocated to such person for the taxable year. The shareholder, partner, or similar person will then include in its wage limitation only those wages which are deducted in arriving at qualified production activities income.

### *Effective Date*

The provision is effective with respect to taxable years beginning after the date of enactment (May 17, 2006).

## N. Modification of Exclusion for Citizens Living Abroad (sec. 515 of the Act and sec. 911 of the Code)

### *Present Law*

#### *In general*

U.S. citizens generally are subject to U.S. income tax on all their income, whether derived in the United States or elsewhere. A U.S. citizen who earns income in a foreign country also may be taxed on that income by the foreign country. The United States generally cedes the primary right to tax a U.S. citizen's non-U.S. source income to the foreign country in which the income is derived. This concession is effected by the allowance of a credit against the U.S. income tax imposed on foreign-source income for foreign taxes paid on that income. The amount of the credit for foreign income tax paid on foreign-source income generally is limited to the amount of U.S. tax otherwise owed on that income. Accordingly, if the amount of foreign tax paid on foreign-source income is less than the amount of U.S. tax owed on that income, a foreign tax credit generally is allowed in an amount not exceeding the amount of the foreign tax, and a residual U.S. tax liability remains.

A U.S. citizen or resident living abroad may be eligible to exclude from U.S. taxable income certain foreign earned income and foreign housing costs.[399] This exclusion applies regardless of whether any foreign tax is paid on the foreign earned income or housing costs. To qualify for these exclusions, an individual (a "qualified individual") must have his or her tax home in a foreign country and must be either (1) a U.S. citizen[400] who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year, or (2) a U.S. citizen or resident present in a foreign country or countries for at least 330 full days in any 12-consecutive-month period.

#### *Exclusion for compensation*

The foreign earned income exclusion generally is available for a qualified individual's non-U.S. source earned income attributable to personal services performed by that individual during the period of

[399] Sec. 911.

[400] Generally, only U.S. citizens may qualify under the bona fide residence test. A U.S. resident alien who is a citizen of a country with which the United States has a tax treaty may, however, quality for the section 911 exclusions under the bona fide residence test by application of a nondiscrimination provision of the treaty.

foreign residence or presence described above. The maximum exclusion amount for any calendar year is $80,000 in 2002 through 2007 and is indexed for inflation after 2007.

### *Exclusion for housing costs*

A qualified individual is allowed an exclusion from gross income (or, as described below, a deduction) for certain foreign housing costs paid or incurred by or on behalf of the individual. The amount of this housing cost exclusion is equal to the excess of a taxpayer's "housing expenses" over a base housing amount. The term "housing expenses" means the reasonable expenses paid or incurred during the taxable year for a taxpayer's housing (and, if they live with the taxpayer, for the housing of the taxpayer's spouse and dependents) in a foreign country. The term includes expenses attributable to housing such as utilities and insurance, but it does not include separately deductible interest and taxes. If the taxpayer maintains a second household outside the United States for a spouse or dependents who do not reside with the taxpayer because of dangerous, unhealthful, or otherwise adverse living conditions, the housing expenses of the second household also are eligible for exclusion. The base housing amount above which costs are eligible for exclusion in a taxable year is 16 percent of the annual salary (computed on a daily basis) of a grade GS–14, step 1, U.S. government employee, multiplied by the number of days of foreign residence or presence (as described above) in the taxable year. For 2006 this salary is $77,793; the current base housing amount therefore is $12,447 (assuming the taxpayer is a bona fide resident of or is present in a foreign country every day during the year).

To the extent otherwise excludable housing costs are not paid or reimbursed by a taxpayer's employer, these costs generally are allowed as a deduction in computing adjusted gross income.

### *Exclusion limitation amounts*

The combined foreign earned income exclusion and housing cost exclusion (including the amount of any deductible housing costs) may not exceed the taxpayer's total foreign earned income for the taxable year. The taxpayer's foreign tax credit is reduced by the amount of the credit that is attributable to excluded income.

### *Tax brackets*

A taxpayer with excludable income under section 911 is subject to tax on the taxpayer's other income, after deductions, starting in the lowest tax rate bracket.

## *Explanation of Provision*

### *Exclusion for compensation*

The provision adjusts for inflation the maximum amount of the foreign earned income exclusion in taxable years beginning in calendar years after 2005 (rather than, as under present law, after 2007). The limitation in 2006 therefore is $82,400.[401]

[401] This $82,400 amount is calculated under section 911(b)(2)(D)(ii), as amended by the provision, using current U.S. Bureau of Labor Statistics ("BLS") Consumer Price Index data.

### *Exclusion for housing costs*

Under the provision, the base housing amount used in calculating the foreign housing cost exclusion in a taxable year is 16 percent of the amount (computed on a daily basis) of the foreign earned income exclusion limitation (instead of the present law 16 percent of the grade GS–14, step 1 amount), multiplied by the number of days of foreign residence or presence (as previously described) in that year.

Reasonable foreign housing expenses in excess of the base housing amount remain excluded from gross income (or, if paid by the taxpayer, are deductible) under the Act, but the amount of the exclusion is limited to 30 percent of the maximum amount of a taxpayer's foreign earned income exclusion.[402] The Secretary is given authority to issue regulations or other guidance providing for the adjustment of this 30-percent housing cost limitation based on geographic differences in housing costs relative to housing costs in the United States. The Congress intends that the Secretary be permitted to use publicly available data, such as the Quarterly Report Indexes published by the U.S. Department of State or any other information deemed reliable by the Secretary, in making adjustments. The Congress also intends that the Secretary may adjust the 30-percent amount upward or downward. The Congress intends that the Secretary make adjustments annually.

Under the 30-percent rule described above, the maximum amount of the foreign housing cost exclusion in 2006 is (assuming foreign residence or presence on all days in the year) $11,536 (= ($82,400 x 30 percent) − ($82,400 x 16 percent)).[403]

### *Tax brackets*

Under the provision, if an individual excludes an amount from income under section 911, any income in excess of the exclusion amount determined under section 911 is taxed (under the regular tax and alternative minimum tax) by applying to that income the tax rates that would have been applicable had the individual not elected the section 911 exclusion. For example, an individual with $80,000 of foreign earned income that is excluded under section 911 and with $20,000 in other taxable income (after deductions) would be subject to tax on that $20,000 at the rate or rates applicable to taxable income in the range of $80,000 to $100,000.

## *Effective Date*

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

---

[402] In certain programs including grant-making to subsidize rents, the U.S. Department of Housing and Urban Development considers maximum affordable housing costs to be 30 percent of a household's income. See, e.g., United States Housing Act of 1937, 42 U.S.C. sec. 1437a(a)(1)(A), as amended.

[403] The $11,536 amount is based on a calculation under section 911(b)(2)(D)(ii), as amended by the provision, using the BLS data described above.

## O. Tax Involvement of Accommodation Parties in Tax Shelter Transactions (sec. 516 of the Act and secs. 6011, 6033, 6652, and new sec. 4965 of the Code)

### *Present Law*

#### *Disclosure of listed and other reportable transactions by taxpayers*

Present law provides that a taxpayer that participates in a reportable transaction (including a listed transaction) and that is required to file a tax return must attach to its return a disclosure statement in the form prescribed by the Secretary.[404] For this purpose, the term taxpayer includes any person, including an individual, trust, estate, partnership, association, company, or corporation.[405]

Under present Treasury regulations, a reportable transaction includes a listed transaction and five other categories of transactions: (1) confidential transactions, which are transactions offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a minimum fee; (2) transactions with contractual protection, which include transactions for which the taxpayer or a related party has the right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained, or for which fees are contingent on the taxpayer's realization of tax benefits from the transaction; (3) loss transactions, which are transactions resulting in the taxpayer claiming a loss under section 165 that exceeds certain thresholds, depending upon the type of taxpayer; (4) transactions with a significant book-tax difference; and (5) transactions involving a brief asset holding period.[406] A listed transaction means 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 section 6011 (relating to the filing of returns and statements), and identified by notice, regulation, or other form of published guidance as a listed transaction.[407] The fact that a transaction is a reportable transaction does not affect the legal determination of whether the taxpayer's treatment of the transaction is proper.[408] Present law authorizes the Secretary to define a reportable transaction on the basis of such transaction being of a type which the Secretary determines as having a potential for tax avoidance or evasion.[409]

Treasury regulations provide guidance regarding the determination of when a taxpayer participates in a transaction for these purposes.[410] A taxpayer has participated in a listed transaction if the taxpayer's tax return reflects tax consequences or a tax strategy described in the published guidance that lists the transaction, or if the taxpayer knows or has reason to know that the taxpayer's tax

---

[404] Treas. Reg. sec. 1.6011–4(a).
[405] Sec. 7701(a)(1); Treas. Reg. sec. 1.6011–4(c)(1).
[406] Treas. Reg. sec. 1.6011–4(b). In Notice 2006–6 (January 6, 2006), the IRS indicated that it was removing transactions with a significant book-tax difference from the categories of reportable transactions.
[407] Sec. 6707A(c)(2); Treas. Reg. sec. 1.6011–4(b)(2).
[408] Treas. Reg. sec. 1.6011–4(a).
[409] Sec. 6707A(c)(1).
[410] Treas. Reg. Sec. 1.6011–4(c)(3).

benefits are derived directly or indirectly from tax consequences of a tax strategy described in published guidance that lists a transaction. A taxpayer has participated in a confidential transaction if the taxpayer's tax return reflects a tax benefit from the transaction and the taxpayer's disclosure of the tax treatment or tax structure of the transaction is limited under conditions of confidentiality. A taxpayer has participated in a transaction with contractual protection if the taxpayer's tax return reflects a tax benefit from the transaction, and the taxpayer has the right to the full or partial refund of fees or the fees are contingent.

Present law provides a penalty for any person who fails to include on any return or statement any required information with respect to a reportable transaction.[411] The penalty applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any other penalty that may be imposed.

The penalty for failing to disclose a reportable transaction is $10,000 in the case of a natural person and $50,000 in any other case. The amounts are increased to $100,000 and $200,000, respectively, if the failure is with respect to a listed transaction. The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the IRS Commissioner may rescind all or a portion of the penalty if rescission would promote compliance with the tax laws and effective tax administration.

### *Disclosure of listed and other reportable transactions by material advisors*

Present law requires each material advisor with respect to any reportable transaction (including any listed transaction) to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe).[412] The information return must include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. The return must be filed by the date specified by the Secretary.

A "material advisor" means any person (1) who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of $250,000 ($50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons) or such other amount as may be prescribed by the Secretary for such advice or assistance.[413]

The Secretary may prescribe regulations which provide (1) that only one material advisor is required to file an information return in cases in which two or more material advisors would otherwise be required to file information returns with respect to a particular reportable transaction, (2) exemptions from the requirements of

[411] Sec. 6707A.
[412] Sec. 6707(a), as added by the American Jobs Creation Act of 2004, Pub. L. No. 108–357, sec. 816(a).
[413] Sec. 6707(b)(1).

this section, and (3) other rules as may be necessary or appropriate to carry out the purposes of this section.[414]

Present law imposes a penalty on any material advisor who fails to timely file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).[415] The amount of the penalty is $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the gross income derived by such person with respect to aid, assistance, or advice which is provided with respect to the transaction before the date the information return that includes the transaction is filed. An intentional failure or act by a material advisor with respect to the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income derived from the transaction.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the IRS Commissioner can rescind all or a portion of the penalty if rescission would promote compliance with the tax laws and effective tax administration.

## *Explanation of Provision*

### *In general*

In general, under the provision, certain tax-exempt entities are subject to penalties for being a party to a prohibited tax shelter transaction. A prohibited tax shelter transaction is a transaction that the Secretary determines is a listed transaction (as defined in section 6707A(c)(2)) or a prohibited reportable transaction. A prohibited reportable transaction is a confidential transaction or a transaction with contractual protection (as defined by the Secretary in regulations) which is a reportable transaction as defined in sec. 6707A(c)(1). Under the provision, a tax-exempt entity is an entity that is described in section 501(c), 501(d), or 170(c) (not including the United States), Indian tribal governments, and tax qualified pension plans, individual retirement arrangements ("IRAs"), and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and qualified tuition plans).

### *Entity level tax*

Under the provision, if a tax-exempt entity is a party at any time to a transaction during a taxable year and knows or has reason to know that the transaction is a prohibited tax shelter transaction, the entity is subject to a tax for such year equal to the greater of (1) 100 percent of the entity's net income (after taking into account any tax imposed with respect to the transaction) for such year that is attributable to the transaction or (2) 75 percent of the proceeds received by the entity that are attributable to the transaction for such year. A tax also is imposed in the event that a tax-exempt entity becomes a party to a prohibited tax shelter transaction without knowing or having reason to know that the transaction is a prohibited tax shelter transaction. In that case, the tax-exempt entity is

[414] Sec. 6707(c).
[415] Sec. 6707(b).

subject to a tax in the taxable year the entity becomes a party and any subsequent taxable year of the highest unrelated business taxable income rate times the greater of (1) the entity's net income (after taking into account any tax imposed with respect to the transaction) for such year that is attributable to the transaction or (2) 75 percent of the proceeds received by the entity that are attributable to the transaction for such year.

In addition, if a transaction is not a listed transaction at the time a tax-exempt entity becomes a party to the transaction (and is not otherwise a prohibited tax shelter transaction), but the transaction subsequently is determined by the Secretary to be a listed transaction (a "subsequently listed transaction"), the entity must pay each taxable year an excise tax equal to the highest unrelated business taxable income rate multiplied by the greater of (1) the entity's net income (after taking into account any tax imposed) that is attributable to the subsequently listed transaction and that is properly allocable to the period beginning on the later of the date such transaction is listed by the Secretary or the first day of the taxable year or (2) 75 percent of the proceeds received by the entity that are attributable to the subsequently listed transaction and that are properly allocable to the period beginning on the later of the date such transaction is listed by the Secretary or the first day of the taxable year. The Secretary has the authority to promulgate regulations that provide guidance regarding the determination of the allocation of net income or proceeds of a tax-exempt entity that is attributable to a transaction to various periods, including before and after the listing of the transaction or the date which is 90 days after the date of enactment of the provision.

There is no reasonable cause exception to imposition of the entity level tax. The entity level tax does not apply to tax qualified pension plans, IRAs, and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and qualified tuition plans).

In general, it is intended that in determining whether a tax-exempt entity is a "party" to a prohibited tax shelter transaction all the facts and circumstances should be taken into account. Absence of a written agreement is not determinative. Certain indirect involvement in a prohibited tax shelter transaction would not result in an entity being considered a party to the transaction. For example, investment by a tax-exempt entity in a mutual fund that in turn invests in or participates in a prohibited tax shelter transaction does not, in general, make the tax-exempt entity a party to such transaction, absent facts or circumstances that indicate that the purpose of the tax exempt entity's investment in the mutual fund was specifically to participate in such a transaction. However, whether a tax-exempt entity is a party to such a transaction will be informed by whether the entity or entity manager knew or had reason to know that an investment of the entity would be used in a prohibited tax shelter transaction. Presence of such knowledge or reason to know may indicate that that the purpose of the investment was to participate in the prohibited tax shelter transaction and that the tax-exempt entity is a party to such transaction.

***Disclosure of being a party to prohibited tax shelter transactions***

The provision requires that a taxable party to a prohibited tax shelter transaction disclose to the tax-exempt entity that the transaction is a prohibited tax shelter transaction. Failure to make such disclosure is subject to the present-law penalty for failure to include reportable transaction information under section 6707A. Thus, the penalty is $10,000 in the case of a natural person or $50,000 in any other case, except that if the transaction is a listed transaction, the penalty is $100,000 in the case of a natural person and $200,000 in any other case.[416]

The provision requires disclosure by a tax-exempt entity to the IRS of being a party to a prohibited tax shelter transaction and disclosure of other known parties to the transaction. The penalty for failure to disclose is imposed on the entity (or entity manager, in the case of qualified pension plans and similar tax favored retirement arrangements) at $100 per day the failure continues, not to exceed $50,000. If any tax-exempt entity or entity manager fails to comply with a demand on the tax-exempt entity or entity manager by the Secretary for disclosure, such person or persons shall pay a penalty of $100 per day (beginning on the date of the failure to comply) not to exceed $10,000 per prohibited tax shelter transaction. As under present-law section 6652, no penalty is imposed with respect to any failure if it is shown that the failure is due to reasonable cause.

***Penalty on entity managers***

A tax of $20,000 is imposed on an entity manager that approves or otherwise causes a tax-exempt entity to be a party to a prohibited tax shelter transaction at any time during the taxable year, knowing or with reason to know that the transaction is a prohibited tax shelter transaction. In the case of tax qualified pension plans, IRAs, and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and qualified tuition plans) an entity manager is the person that approves or otherwise causes the entity to be a party to a prohibited tax shelter transaction. In all other cases the entity manager is the person with authority or responsibility similar to that exercised by an officer, director, or trustee of an organization, and with respect to any act, the person having authority or responsibility with respect to such act.

In the case of a qualified pension plan, IRA, or similar tax-favored savings arrangement (such as a Coverdell education savings account, health savings account, or qualified tuition plan), it is intended that, in general, a person who decides that assets of the plan, IRA, or other savings arrangement are to be invested in a prohibited tax shelter transaction is the entity manager under the provision. Except in the case of a fully self-directed plan or other savings arrangement with respect to which a participant or beneficiary decides to invest in the prohibited tax shelter transaction,

[416] The IRS Commissioner may rescind all or any portion of any such penalty if the violation is with respect to a prohibited tax shelter transaction other than a listed transaction and doing so would promote compliance with the requirements of the Code and effective tax administration. See sec. 6707A(d).

a participant or beneficiary generally is not an entity manager under the provision. Thus, for example, a participant or beneficiary is not an entity manager merely by reason of choosing among preselected investment options (as is typically the case if a qualified retirement plan provides for participant-directed investments).[417] Similarly, if an individual has an IRA and may choose among various mutual funds offered by the IRA trustee, but has no control over the investments held in the mutual funds, the individual is not an entity manager under the provision.

***Reason to know standard***

In general, it is intended that in order for an entity or entity manager to have reason to know that a transaction is a prohibited tax shelter transaction, the entity or entity manager must have knowledge of sufficient facts that would lead a reasonable person to conclude that the transaction is a prohibited tax shelter transaction. If there is justifiable reliance on a reasoned written opinion of legal counsel (including in-house counsel) or of an independent accountant with expertise in tax matters, after making full disclosure of relevant facts about a transaction to such counsel or accountant, that a transaction is not a prohibited tax shelter transaction, then absent knowledge of facts not considered in the reasoned written opinion that would lead a reasonable person to conclude that the transaction is a prohibited tax shelter transaction, the reason to know standard is not met.

Not obtaining a reasoned written opinion of legal counsel does not alone indicate whether a person has reason to know. However, if a transaction is extraordinary for the entity, promises a return for the organization that is exceptional considering the amount invested by, the participation of, or the absence of risk to the organization or the transaction is of significant size, either in an absolute sense or relative to the receipts of the entity, then, in general, the presence of such factors may indicate that the entity or entity manager has a responsibility to inquire further about whether a transaction is a prohibited tax shelter transaction, or, absent such inquiry, that the reason to know standard is satisfied. For example, if a tax-exempt entity's investment in a transaction is $1,000, and the entity is promised or expects to receive $10,000 in the near term, in general, the rate of return would be considered exceptional and the entity should make inquiries with respect to the transaction. As another example, if a tax-exempt entity's expected income from a transaction is greater than five percent of the entity's annual receipts, or is in excess of $1,000,000, and the entity fails to make appropriate inquiries with respect to its participation in such transaction, such failure is a factor tending to show that the reason to know standard is met. Appropriate inquiries need not involve obtaining a reasoned written opinion. In general, if a transaction does not present the factors described above and the organization is small (measured by receipts and assets) and described in section 501(c)(3), it is expected that the reason to know standard will not be met.

[417] Depending on the circumstances, the person who is responsible for determining the preselected investment options may be an entity manager under the provision.

### *Effective Date*

In general, the provision is effective for taxable years ending after the date of enactment (May 17, 2006), with respect to transactions before, on, or after such date, except that no tax shall apply with respect to income or proceeds that are properly allocable to any period ending on or before the date that is 90 days after the date of enactment (May 17, 2006). The tax on certain knowing transactions does not apply to any prohibited tax shelter transaction to which a tax-exempt entity became a party on or before the date of enactment (May 17, 2006). The disclosure provisions apply to disclosures the due date for which are after the date of enactment (May 17, 2006).

## PART TWELVE: HEROES EARNED RETIREMENT OPPORTUNITIES ACT (PUBLIC LAW 109–227)[418]

### A. Combat Zone Compensation Taken into Account for Purposes of Determining Limitation and Deductibility of Contributions to Individual Retirement Plans (sec. 2 of the Act and sec. 219(f) of the Code)

#### *Present Law*

There are two general types of individual retirement arrangements ("IRAs"): traditional IRAs and Roth IRAs (secs. 408 and 408A). The total amount that an individual may contribute to one or more IRAs for a year is generally limited to the lesser of: (1) a dollar amount ($4,000 for 2006); and (2) the amount of the individual's compensation that is includible in gross income for the year. In the case of an individual who has attained age 50 before the end of the year, the dollar amount is increased by an additional amount ($1,000 for 2006). In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses that is includible in gross income is at least equal to the contributed amount. IRA contributions in excess of the applicable limit are generally subject to an excise tax of six percent per year until withdrawn.

An individual may make contributions to a traditional IRA (up to the contribution limit) without regard to his or her adjusted gross income. An individual may deduct his or her contributions to a traditional IRA if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual or the individual's spouse is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income over certain levels.

Individuals with adjusted gross income below certain levels may make contributions to a Roth IRA (up to the contribution limit). Contributions to a Roth IRA are not deductible.

An IRA contribution can be made after the end of the year to which the contribution relates if made not later than the due date (without regard to extensions) of the tax return for the year. In that case, the IRA contribution is deemed to be made on the last day of the year to which it relates.

Present law provides an exclusion from gross income for combat pay received by members of the Armed Forces (sec. 112). Thus,

[418] H.R. 1499. The House passed the bill on the suspension calendar on May 23, 2005. The Senate passed the bill with an amendment by unanimous consent on November 15, 2005. The House agreed to the Senate amendment with an amendment on May 9, 2006. The Senate agreed to the House amendment by unanimous consent on May 18, 2006. The President signed the bill on May 29, 2006.

combat pay is not includible compensation for purposes of applying the limit on IRA contributions.

In general, a taxpayer must file a claim for credit or refund of an overpayment of tax within three years of the filing of the tax return or within two years of the payment of the tax, whichever expires later (sec. 6511(a)).[419] A claim for credit or refund that is not filed within these time periods is rejected as untimely. Assessment of a tax deficiency generally must be made within three years of the filing of the tax return (sec. 6501(a)).

### *Explanation of Provision*

Under the provision, for purposes of applying the limit on IRA contributions, an individual's gross income is determined without regard to the exclusion for combat pay. Thus, combat pay received by an individual is treated as includible compensation for purposes of determining the amount that the individual (and the individual's spouse) can contribute to an IRA.

The provision includes a special rule providing an extended period for making IRA contributions attributable to excludible combat pay for taxable years beginning after December 31, 2003 (for which the provision is effective), and ending before the date of enactment. Under the special rule, a contribution for such a year made not later than the last day of the three-year period beginning on the date of enactment of the provision (May 29, 2006) is treated as having been made on the last day of the taxable year. Thus, such contributions made within the three-year period are considered timely. If such a contribution results in a tax overpayment for the year for which the contribution is made, a claim for credit or refund of the overpayment is considered timely if filed before the close of the one-year period beginning on the date the contribution is actually made. The period for assessing a tax deficiency attributable to such a contribution does not expire before the close of the three-year period beginning on the date the contribution is made.

### *Effective Date*

The provision is effective for taxable years beginning after December 31, 2003.

[419] If no tax return is filed, the two-year limit applies.

# PART THIRTEEN: PENSION PROTECTION ACT OF 2006 (PUBLIC LAW 109–280)[420]

## TITLE I—REFORM OF FUNDING RULES FOR SINGLE-EMPLOYER DEFINED BENEFIT PENSION PLANS

### A. Minimum Funding Standards for Single-Employer Defined Benefit Pension Plans (secs. 101, 102, 107, 111, 112, 114, and 301 of the Act, secs. 302–308 of ERISA, and sec. 412 and new sec. 430 of the Code)

#### *Present Law*

#### *In general*

Single-employer defined benefit pension plans are subject to minimum funding requirements under the Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code (the "Code").[421] The amount of contributions required for a plan year under the minimum funding rules is generally the amount needed to fund benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit. The amount of required annual contributions is determined under one of a number of acceptable actuarial cost methods. Additional contributions are required under the deficit reduction contribution rules in the case of certain underfunded plans. No contribution is required under the minimum funding rules in excess of the full funding limit (described below).

#### *General minimum funding rules*

*Funding standard account*

As an administrative aid in the application of the funding requirements, a defined benefit pension plan is required to maintain a special account called a "funding standard account" to which specified charges and credits are made for each plan year, including a charge for normal cost and credits for contributions to the

[420] H.R. 4. The House passed the bill on July 28, 2006. The Senate passed the bill on August 3, 2006. The President signed the bill on August 17, 2006. Some provisions that are identical or similar to the pension provisions in the Act were contained in other bills reported by the House Committees on Ways and Means and Education and the Workforce and the Senate Committees on Finance and Health, Education, Labor, and Pensions, or passed by the House or the Senate during the 109th Congress. These bills include H.R. 2830, S. 1953, and S. 1783. For a technical explanation of the bill prepared by the staff of the Joint Committee on Taxation, see Joint Committee on Taxation, *Technical Explanation of H.R. 4, the "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006* (JCX–38–06), August 3, 2006. For references to the technical explanation, see 152 Cong. Rec. H. 6158 (July 28, 2006) and 152 Cong. Rec. S. 8763 (August 3, 2006).

[421] Multiemployer defined benefit pension plans are also subject to the minimum funding requirements, but the rules for multiemployer plans differ in various respects from the rules applicable to single-employer plans. Governmental plans and church plans are generally exempt from the minimum funding requirements.

plan. Other charges or credits may apply as a result of decreases or increases in past service liability as a result of plan amendments, experience gains or losses, gains or losses resulting from a change in actuarial assumptions, or a waiver of minimum required contributions.

In determining plan funding under an actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. If the plan's actual unfunded liabilities are less than those anticipated by the actuary on the basis of these assumptions, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. Experience gains and losses for a year are generally amortized as credits or charges to the funding standard account over five years.

If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from changes in actuarial assumptions. If the new assumptions result in an increase in the plan's accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost or future employee contributions. The gain or loss for a year from changes in actuarial assumptions is amortized as credits or charges to the funding standard account over ten years.

If minimum required contributions are waived (as discussed below), the waived amount (referred to as a "waived funding deficiency") is credited to the funding standard account. The waived funding deficiency is then amortized over a period of five years, beginning with the year following the year in which the waiver is granted. Each year, the funding standard account is charged with the amortization amount for that year unless the plan becomes fully funded.

If, as of the close of a plan year, the funding standard account reflects credits at least equal to charges, the plan is generally treated as meeting the minimum funding standard for the year. If, as of the close of the plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an "accumulated funding deficiency." Thus, as a general rule, the minimum contribution for a plan year is determined as the amount by which the charges to the funding standard account would exceed credits to the account if no contribution were made to the plan. For example, if the balance of charges to the funding standard account of a plan for a year would be $200,000 without any contributions, then a minimum contribution equal to that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency.

*Credit balances*

If credits to the funding standard account exceed charges, a "credit balance" results. A credit balance results, for example, if

contributions in excess of minimum required contributions are made. Similarly, a credit balance may result from large net experience gains. The amount of the credit balance, increased with interest at the rate used under the plan to determine costs, is applied against charges to the funding standard account, thus reducing required contributions.

*Funding methods and general concepts*

A defined benefit pension plan is required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as: (1) normal cost; and (2) supplemental cost.

The plan's normal cost for a plan year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. Specifically, it is the amount actuarially determined that would be required as a contribution by the employer for the plan year in order to maintain the plan if the plan had been in effect from the beginning of service of the included employees and if the costs for prior years had been paid, and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. The normal cost will be funded by future contributions to the plan: (1) in level dollar amounts; (2) as a uniform percentage of payroll; (3) as a uniform amount per unit of service (e.g., $1 per hour); or (4) on the basis of the actuarial present values of benefits considered accruing in particular plan years.

The supplemental cost for a plan year is the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets. The most common supplemental cost is that attributable to past service liability, which represents the cost of future benefits under the plan: (1) on the date the plan is first effective; or (2) on the date a plan amendment increasing plan benefits is first effective. Other supplemental costs may be attributable to net experience losses, changes in actuarial assumptions, and amounts necessary to make up funding deficiencies for which a waiver was obtained. Supplemental costs must be amortized (i.e., recognized for funding purposes) over a specified number of years, depending on the source. For example, the cost attributable to a past service liability is generally amortized over 30 years.

Normal costs and supplemental costs under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. An actuarial valuation is generally required annually and is made as of a date within the plan year or within one month before the beginning of the plan year. However, a valuation date within the preceding plan year may be used if, as of that date, the value of the plan's assets is at least 100 percent of the plan's current liability (i.e., the present value of benefits under the plan, as described below).

For funding purposes, the actuarial value of plan assets may be used, rather than fair market value. The actuarial value of plan assets is the value determined on the basis of a reasonable actuarial

valuation method that takes into account fair market value and is permitted under Treasury regulations. Any actuarial valuation method used must result in a value of plan assets that is not less than 80 percent of the fair market value of the assets and not more than 120 percent of the fair market value. In addition, if the valuation method uses average value of the plan assets, values may be used for a stated period not to exceed the five most recent plan years, including the current year.

In applying the funding rules, all costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods, each of which is reasonable (taking into account the experience of the plan and reasonable expectations), or which, in the aggregate, result in a total plan contribution equivalent to a contribution that would be determined if each assumption and method were reasonable. In addition, the assumptions are required to offer the actuary's best estimate of anticipated experience under the plan.[422]

### *Additional contributions for underfunded plans*

#### *In general*

Under special funding rules (referred to as the "deficit reduction contribution" rules),[423] an additional charge to a plan's funding standard account is generally required for a plan year if the plan's funded current liability percentage for the plan year is less than 90 percent.[424] A plan's "funded current liability percentage" is generally the actuarial value of plan assets as a percentage of the plan's current liability.[425] In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan, determined on a present-value basis.

The amount of the additional charge required under the deficit reduction contribution rules is the sum of two amounts: (1) the excess, if any, of (a) the deficit reduction contribution (as described below), over (b) the contribution required under the normal funding rules; and (2) the amount (if any) required with respect to unpredictable contingent event benefits. The amount of the additional charge cannot exceed the amount needed to increase the plan's funded current liability percentage to 100 percent (taking into account the expected increase in current liability due to benefits accruing during the plan year).

The deficit reduction contribution is generally the sum of (1) the "unfunded old liability amount," (2) the "unfunded new liability

---

[422] Under present law, certain changes in actuarial assumptions that decrease the liabilities of an underfunded single-employer plan must be approved by the Secretary of the Treasury.

[423] The deficit reduction contribution rules apply to single-employer plans, other than single-employer plans with no more than 100 participants on any day in the preceding plan year. Single-employer plans with more than 100 but not more than 150 participants are generally subject to lower contribution requirements under these rules.

[424] Under an alternative test, a plan is not subject to the deficit reduction contribution rules for a plan year if (1) the plan's funded current liability percentage for the plan year is at least 80 percent, and (2) the plan's funded current liability percentage was at least 90 percent for each of the two immediately preceding plan years or each of the second and third immediately preceding plan years.

[425] In determining a plan's funded current liability percentage for a plan year, the value of the plan's assets is generally reduced by the amount of any credit balance under the plan's funding standard account. However, this reduction does not apply in determining the plan's funded current liability percentage for purposes of whether an additional charge is required under the deficit reduction contribution rules.

amount," and (3) the expected increase in current liability due to benefits accruing during the plan year.[426] The "unfunded old liability amount" is the amount needed to amortize certain unfunded liabilities under 1987 and 1994 transition rules. The "unfunded new liability amount" is the applicable percentage of the plan's unfunded new liability. Unfunded new liability generally means the unfunded current liability of the plan (i.e., the amount by which the plan's current liability exceeds the actuarial value of plan assets), but determined without regard to certain liabilities (such as the plan's unfunded old liability and unpredictable contingent event benefits). The applicable percentage is generally 30 percent, but decreases by .40 of one percentage point for each percentage point by which the plan's funded current liability percentage exceeds 60 percent. For example, if a plan's funded current liability percentage is 85 percent (i.e., it exceeds 60 percent by 25 percentage points), the applicable percentage is 20 percent (30 percent minus 10 percentage points (25 multiplied by .4)).[427]

A plan may provide for unpredictable contingent event benefits, which are benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce. The value of any unpredictable contingent event benefit is not considered in determining additional contributions until the event has occurred. The event on which an unpredictable contingent event benefit is contingent is generally not considered to have occurred until all events on which the benefit is contingent have occurred.

*Required interest rate and mortality table*

Specific interest rate and mortality assumptions must be used in determining a plan's current liability for purposes of the special funding rule. For plans years beginning before January 1, 2004, and after December 31, 2005, the interest rate used to determine a plan's current liability must be within a permissible range of the weighted average of the interest rates on 30-year Treasury securities for the four-year period ending on the last day before the plan year begins.[428] The permissible range is generally from 90 percent to 105 percent (120 percent for plan years beginning in 2002 or 2003).[429] The interest rate used under the plan generally must be consistent with the assumptions which reflect the purchase rates that would be used by insurance companies to satisfy the liabilities under the plan.[430]

---

[426] The deficit reduction contribution may also include an additional amount as a result of the use of a new mortality table prescribed by the Secretary of the Treasury in determining current liability for plan years beginning after 2006, as described below.

[427] In making these computations, the value of the plan's assets is reduced by the amount of any credit balance under the plan's funding standard account.

[428] The weighting used for this purpose is 40 percent, 30 percent, 20 percent and 10 percent, starting with the most recent year in the four-year period. Notice 88–73, 1988–2 C.B. 383.

[429] If the Secretary of the Treasury determines that the lowest permissible interest rate in this range is unreasonably high, the Secretary may prescribe a lower rate, but not less than 80 percent of the weighted average of the 30-year Treasury rate.

[430] Code sec. 412(b)(5)(B)(iii)(II); ERISA sec. 302(b)(5)(B)(iii)(II). Under Notice 90–11, 1990–1 C.B. 319, the interest rates in the permissible range are deemed to be consistent with the assumptions reflecting the purchase rates that would be used by insurance companies to satisfy the liabilities under the plan.

Under the Pension Funding Equity Act of 2004 ("PFEA 2004"),[431] a special interest rate applies in determining current liability for plan years beginning in 2004 or 2005.[432] For these years, the interest rate used must be within a permissible range of the weighted average of the rates of interest on amounts invested conservatively in long-term investment-grade corporate bonds during the four-year period ending on the last day before the plan year begins. The permissible range for these years is from 90 percent to 100 percent. The interest rate is to be determined by the Secretary of the Treasury on the basis of two or more indices that are selected periodically by the Secretary and are in the top three quality levels available.

In determining current liability, the 1983 Group Annuity Mortality Table has been used since 1995.[433] Under present law, the Secretary of the Treasury may prescribe other tables to be used based on the actual experience of pension plans and projected trends in such experience. In addition, the Secretary of the Treasury is required to periodically review (at least every five years) any tables in effect and, to the extent the Secretary determines necessary, update such tables to reflect the actuarial experience of pension plans and projected trends in such experience.[434] Under Prop. Treas. Reg. 1.412(l)(7)–1, beginning in 2007, RP–2000 Mortality Tables are used with improvements in mortality (including future improvements) projected to the current year and with separate tables for annuitants and nonannuitants.[435]

### *Other rules*

#### *Full funding limitation*

No contributions are required under the minimum funding rules in excess of the full funding limitation. The full funding limitation is the excess, if any, of (1) the accrued liability under the plan (including normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets.[436] However, the full funding limitation may not be less than the excess, if any, of 90 percent of the plan's current liability (including the expected increase in current liability due to benefits accruing during the plan year) over the actuarial value of plan assets. In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability under the full fund-

---

[431] Pub. L. No. 108–218 (2004).

[432] In addition, under PFEA 2004, if certain requirements are met, reduced contributions under the deficit reduction contribution rules apply for plan years beginning after December 27, 2003, and before December 28, 2005, in the case of plans maintained by commercial passenger airlines, employers primarily engaged in the production or manufacture of a steel mill product or in the processing of iron ore pellets, or a certain labor organization.

[433] Rev. Rul. 95–28, 1995–1 C.B. 74. Separate mortality tables are required to be used with respect to disabled participants.

[434] Code sec. 412(l)(7)(C)(ii)(III); ERISA sec. 302(d)(7)(C)(ii)(III).

[435] Separate tables continue to apply with respect to disabled participants.

[436] For plan years beginning before 2004, the full funding limitation was generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) a percentage (170 percent for 2003) of the plan's current liability (including the current liability normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets, but in no case less than the excess, if any, of 90 percent of the plan's current liability over the actuarial value of plan assets. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the full funding limitation based on 170 percent of current liability is repealed for plan years beginning in 2004 and thereafter. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

ing limitation may be based on projected future benefits, including future salary increases.

*Timing of plan contributions*

In general, plan contributions required to satisfy the funding rules must be made within 8½ months after the end of the plan year. If the contribution is made by such due date, the contribution is treated as if it were made on the last day of the plan year.

In the case of a plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year.[437] The amount of each required installment is generally 25 percent of the lesser of (1) 90 percent of the amount required to be contributed for the current plan year or (2) 100 percent of the amount required to be contributed for the preceding plan year.[438] If a required installment is not made, interest applies for the period of underpayment at a rate of the greater of (1) 175 percent of the Federal mid-term rate, or (2) the plan rate.

*Funding waivers*

Within limits, the Secretary of the Treasury is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year (a "waived funding deficiency").[439] A waiver may be granted if the employer (or employers) responsible for the contribution could not make the required contribution without temporary substantial business hardship and if requiring the contribution would be adverse to the interests of plan participants in the aggregate. Generally, no more than three waivers may be granted within any period of 15 consecutive plan years.

The IRS is authorized to require security to be provided as a condition of granting a waiver of the minimum funding standard if the sum of the plan's accumulated funding deficiency and the balance of any outstanding waived funding deficiencies exceeds $1 million.

*Failure to make required contributions*

An employer is generally subject to an excise tax if it fails to make minimum required contributions and fails to obtain a waiver from the IRS.[440] The excise tax is 10 percent of the amount of the accumulated funding deficiency. In addition, a tax of 100 percent may be imposed if the accumulated funding deficiency is not corrected within a certain period.

If the total of the contributions the employer fails to make (plus interest) exceeds $1 million and the plan's funded current liability percentage is less than 100 percent, a lien arises in favor of the plan with respect to all property of the employer and the members

[437] Code sec. 412(m); ERISA sec. 302(e).

[438] If quarterly contributions are required with respect to a plan, the amount of a quarterly installment must also be sufficient to cover any shortfall in the plan's liquid assets (a "liquidity shortfall").

[439] Code sec. 412(d); ERISA sec. 303. Under similar rules, the amortization period applicable to an unfunded past service liability or loss may also be extended.

[440] Code sec. 4971. An excise tax applies also if a quarterly installment is less than the amount required to cover the plan's liquidity shortfall.

of the employer's controlled group. The amount of the lien is the total amount of the missed contributions (plus interest).

### *Explanation of Provision*

#### *Interest rate required for plan years beginning in 2006 and 2007*

For plan years beginning after December 31, 2005, and before January 1, 2008, the provision applies the present-law funding rules, with an extension of the interest rate applicable in determining current liability for plan years beginning in 2004 and 2005. Thus, in determining current liability for funding purposes for plan years beginning in 2006 and 2007, the interest rate used must be within the permissible range (90 to 100 percent) of the weighted average of the rates of interest on amounts invested conservatively in long-term investment-grade corporate bonds during the four-year period ending on the last day before the plan year begins.

#### *Funding rules for plan years beginning after 2007—in general*

For plan years beginning after December 31, 2007, in the case of single-employer defined benefit plans, the provision repeals the present-law funding rules (including the requirement that a funding standard account be maintained) and provides a new set of rules for determining minimum required contributions.[441] Under the provision, the minimum required contribution to a single-employer defined benefit pension plan for a plan year generally depends on a comparison of the value of the plan's assets with the plan's funding target and target normal cost. As described in more detail below, under the provision, credit balances generated under present law are carried over (into a "funding standard carryover balance") and generally may be used in certain circumstances to reduce otherwise required minimum contributions. In addition, as described more fully below, contributions in excess of the minimum contributions required under the provision for plan years beginning after 2007 generally are credited to a prefunding balance that may be used in certain circumstances to reduce otherwise required minimum contributions. To facilitate the use of such balances to reduce minimum required contributions, while avoiding use of such balances for more than one purpose, in some circumstances the value of plan assets is reduced by the prefunding balance and/or the funding standard carryover balance.

The minimum required contribution for a plan year, based on the value of plan assets (reduced by any prefunding balance and funding standard carryover balance) compared to the funding target, is shown in the following table:

[441] A delayed effective date applies to certain plans as discussed in Items C, D and E below. Changes to the funding rules for multiemployer plans are discussed in Title II below. Governmental plans and church plans continue to be exempt from the funding rules to the extent provided under present law.

| If: | The minimum required contribution is: |
|---|---|
| the value of plan assets (reduced by any prefunding balance and funding standard carryover balance) is less than the funding target | the sum of: (1) target normal cost; (2) any shortfall amortization charge; and (3) any waiver amortization charge. |
| the value of plan assets (reduced by any prefunding balance and funding standard carryover balance) equals or exceeds the funding target | the target normal cost, reduced (but not below zero) by the excess of (1) the value of plan assets (reduced by any prefunding balance and funding standard carryover balance), over (2) the funding target. |

Under the provision, a plan's funding target is the present value of all benefits accrued or earned as of the beginning of the plan year. A plan's target normal cost for a plan year is the present value of benefits expected to accrue or be earned during the plan year. A shortfall amortization charge is generally the sum of the amounts required to amortize any shortfall amortization bases for the plan year and the six preceding plan years. A shortfall amortization base is generally required to be established for a plan year if the plan has a funding shortfall for a plan year.[442] A shortfall amortization base may be positive or negative, i.e., an offsetting amortization base is established for gains. In general, a plan has a funding shortfall if the plan's funding target for the year exceeds the value of the plan's assets (reduced by any prefunding balance and funding standard carryover balance). A waiver amortization charge is the amount required to amortize a waived funding deficiency.

The provision specifies the interest rates and mortality table that must be used in determining a plan's target normal cost and funding target, as well as certain other actuarial assumptions, including special assumptions ("at-risk" assumptions) for a plan in at-risk status. A plan is in at-risk status for a year if the value of the plan's assets (reduced by any prefunding and funding standard carryover balances) for the preceding year was less than (1) 80 percent of the plan's funding target determined without regard to the at-risk assumptions, and (2) 70 percent of the plan's funding target determined using the at-risk assumptions. Under a transition rule, instead of 80 percent, the following percentages apply: 65 percent for 2008, 70 percent for 2009, and 75 percent for 2010.

### *Target normal cost*

Under the provision, the minimum required contribution for a plan year generally includes the plan's target normal cost for the plan year. A plan's target normal cost is the present value of all

[442] Under a special rule, discussed below, a shortfall amortization base does not have to be established if the value of a plan's assets (reduced by any prefunding balance, but only if the employer elects to use any portion of the prefunding balance to reduce required contributions for the year) is at least equal to the plan's funding target for the plan year.

benefits expected to accrue or be earned under the plan during the plan year (the "current" year). For this purpose, an increase in any benefit attributable to services performed in a preceding year by reason of a compensation increase during the current year is treated as having accrued during the current year.

If the value of a plan's assets (reduced by any funding standard carryover balance and prefunding balance) exceeds the plan's funding target for a plan year, the minimum required contribution for the plan year is target normal cost reduced by such excess (but not below zero).

### *Funding target and shortfall amortization charges*

#### *In general*

If the value of a plan's assets (reduced by any funding standard carryover balance and prefunding balance) is less than the plan's funding target for a plan year, so that the plan has a funding shortfall,[443] the minimum required contribution is generally increased by a shortfall amortization charge. As discussed more fully below, the shortfall amortization charge is the aggregate total (not less than zero) of the shortfall amortization installments for the plan year with respect to any shortfall amortization bases for the plan year and the six preceding plan years.

#### *Funding target*

A plan's funding target for a plan year is the present value of all benefits accrued or earned under the plan as of the beginning of the plan year. For this purpose, all benefits (including early retirement or similar benefits) are taken into account. Benefits accruing in the plan year are not taken into account in determining the plan's funding target, regardless of whether the valuation date for the plan year is later than the first day of the plan year.[444]

#### *Shortfall amortization charge*

The shortfall amortization charge for a plan year is the aggregate total (not less than zero) of the shortfall amortization installments for the plan year with respect to any shortfall amortization bases for that plan year and the six preceding plan years. The shortfall amortization installments with respect to a shortfall amortization base for a plan year are the amounts necessary to amortize the shortfall amortization base in level annual installments over the seven-plan-year period beginning with the plan year. The shortfall amortization installment with respect to a shortfall amortization base for any plan year in the seven-year period is the annual installment determined for that year for that shortfall amortization base. Shortfall amortization installments are determined using the appropriate segment interest rates (discussed below).

---

[443] Under a special rule, in determining a plan's funding shortfall, the value of plan assets is not reduced by any funding standard carryover balance or prefunding balance if, with respect to the funding standard carryover balance or prefunding balance, there is in effect for the year a binding written agreement with the Pension Benefit Guaranty Corporation which provides that such balance is not available to reduce the minimum required contribution for the plan year.

[444] Benefits accruing during the plan year are taken into account in determining normal cost for the plan year.

*Shortfall amortization base and phase-in of funding target*

A shortfall amortization base is determined for a plan year based on the plan's funding shortfall for the plan year. The funding shortfall is the amount (if any) by which the plan's funding target for the year exceeds the value of the plan's assets (reduced by any funding standard carryover balance and prefunding balance).

The shortfall amortization base for a plan year is (1) the plan's funding shortfall, minus (2) the present value, determined using the segment interest rates (discussed below), of the aggregate total of the shortfall amortization installments and waiver amortization installments that have been determined for the plan year and any succeeding plan year with respect to any shortfall amortization bases and waiver amortization bases for preceding plan years.

A shortfall amortization base may be positive or negative, depending on whether the present value of remaining installments with respect to prior year amortization bases is more or less than the plan's funding shortfall. In either case, the shortfall amortization base is amortized over seven years. Shortfall amortization installments for a particular plan year with respect to positive and negative shortfall amortization bases are netted in determining the shortfall amortization charge for the plan year, but the resulting shortfall amortization charge cannot be less than zero. Thus, negative amortization installments may not offset waiver amortization installments or normal cost.

Under a special rule, a shortfall amortization base does not have to be established for a plan year if the value of a plan's assets (reduced by any prefunding balance, but only if the employer elects to use any portion of the prefunding balance to reduce required contributions for the year) is at least equal to the plan's funding target for the plan year. For purposes of the special rule, a transition rule applies for plan years beginning after 2007 and before 2011. The transition rule does not apply to a plan that (1) is not in effect for 2007, or (2) is subject to the present-law deficit reduction contribution rules for 2007 (i.e., a plan covering more than 100 participants and with a funded current liability below the applicable threshold).

Under the transition rule, a shortfall amortization base does not have to be established for a plan year during the transition period if the value of plan assets (reduced by any prefunding balance, but only if the employer elects to use the prefunding balance to reduce required contributions for the year) for the plan year is at least equal to the applicable percentage of the plan's funding target for the year. The applicable percentage is 92 percent for 2008, 94 percent for 2009, and 96 percent for 2010. However, the transition rule does not apply to a plan for any plan year after 2008 unless, for each preceding plan year after 2007, the plan's shortfall amortization base was zero (i.e., the plan was eligible for the special rule each preceding year).

*Early deemed amortization of funding shortfalls for preceding years*

If a plan's funding shortfall for a plan year is zero (i.e., the value of the plan's assets, reduced by any funding standard carryover balance and prefunding balance, is at least equal to the plan's

funding target for the year), any shortfall amortization bases for preceding plan years are eliminated. That is, for purposes of determining any shortfall amortization charges for that year and succeeding years, the shortfall amortization bases for all preceding years (and all shortfall amortization installments determined with respect to such bases) are reduced to zero.

### *Waiver amortization charges*

The provision retains the present-law rules under which the Secretary of the Treasury may waive all or a portion of the contributions required under the minimum funding standard for a plan year (referred to as a "waived funding deficiency").[445] If a plan has a waived funding deficiency for any of the five preceding plan years, the minimum required contribution for the plan year is increased by the waiver amortization charge for the plan year.

The waiver amortization charge for a plan year is the aggregate total of the waiver amortization installments for the plan year with respect to any waiver amortization bases for the five preceding plan years. The waiver amortization installments with respect to a waiver amortization base for a plan year are the amounts necessary to amortize the waiver amortization base in level annual installments over the five-year plan period beginning with the succeeding plan year. The waiver amortization installment with respect to that waiver amortization base for any plan year in the five-year period is the annual installment determined for the shortfall amortization base. Waiver amortization installments are determined using the appropriate segment interest rates (discussed below). The waiver amortization base for a plan year is the amount of the waived funding deficiency (if any) for the plan year.

If a plan's funding shortfall for a plan year is zero (i.e., the value of the plan's assets, reduced by any funding standard carryover balance and prefunding balance, is at least equal to the plan's funding target for the year), any waiver amortization bases for preceding plan years are eliminated. That is, for purposes of determining any waiver amortization charges for that year and succeeding years, the waiver amortization bases for all preceding years (and all waiver amortization installments determined with respect to such bases) are reduced to zero.

### *Actuarial assumptions used in determining a plan's target normal cost and funding target*

#### *Interest rates*

The provision specifies the interest rates that must be used in determining a plan's target normal cost and funding target. Under the provision, present value is determined using three interest rates ("segment" rates), each of which applies to benefit payments expected to be made from the plan during a certain period. The first segment rate applies to benefits reasonably determined to be payable during the five-year period beginning on the first day of the plan year; the second segment rate applies to benefits reason-

[445] In the case of single-employer plans, the provision repeals the present-law rules under which the amortization period applicable to an unfunded past service liability or loss may be extended.

ably determined to be payable during the 15-year period following the initial five-year period; and the third segment rate applies to benefits reasonably determined to be payable the end of the 15-year period. Each segment rate is a single interest rate determined monthly by the Secretary of the Treasury on the basis of a corporate bond yield curve, taking into account only the portion of the yield curve based on corporate bonds maturing during the particular segment rate period.

The corporate bond yield curve used for this purpose is to be prescribed on a monthly basis by the Secretary of the Treasury and reflect the average, for the 24-month period ending with the preceding month, of yields on investment grade corporate bonds with varying maturities and that are in the top three quality levels available. The yield curve should reflect the average of the rates on all bonds in the top three quality levels on which the yield curve is based.

The Secretary of the Treasury is directed to publish each month the corporate bond yield curve and each of the segment rates for the month. In addition, such Secretary is directed to publish a description of the methodology used to determine the yield curve and segment rates, which is sufficiently detailed to enable plans to make reasonable projections regarding the yield curve and segment rates for future months, based on a plan's projection of future interest rates.

Under the provision, the present value of liabilities under a plan is determined using the segment rates for the "applicable month" for the plan year. The applicable month is the month that includes the plan's valuation date for the plan year, or, at the election of the plan sponsor, any of the four months preceding the month that includes the valuation date. An election of a preceding month applies to the plan year for which it is made and all succeeding plan years unless revoked with the consent of the Secretary of the Treasury.

Solely for purposes of determining minimum required contributions, in lieu of the segment rates described above, an employer may elect to use interest rates on a yield curve based on the yields on investment grade corporate bonds for the month preceding the month in which the plan year begins (i.e., without regard to the 24-month averaging described above). Such an election may be revoked only with consent of the Secretary of the Treasury.

The provision provides a transition rule for plan years beginning in 2008 and 2009 (other than for plans first effective after December 31, 2007). Under this rule, for plan years beginning in 2008, the first, second, or third segment rate with respect to any month is the sum of: (1) the product of the segment rate otherwise determined for the month, multiplied by 33⅓ percent; and (2) the product of the applicable long-term corporate bond rate,[446] multiplied by 66⅔ percent. For plan years beginning in 2009, the first, second, or third segment rate with respect to any month is the sum of: (1) the product of the segment rate otherwise determined for the month, multiplied by 66⅔ percent; and (2) the product of applica-

[446] The applicable long-term corporate bond rate is a rate that is from 90 to 100 percent of the weighted average of the rates of interest on amounts invested conservatively in long-term investment-grade corporate bonds during the four-year period ending on the last day before the plan year begins as determined by the Secretary under the method in effect for 2007.

ble long-term corporate bond rate multiplied by 33⅓ percent. An employer may elect not to have the transition rule apply with respect to a plan. Such an election may be revoked only with consent of the Secretary of the Treasury.

Under the provision, certain amounts are determined using the plan's "effective interest rate" for a plan year. The effective interest rate with respect to a plan for a plan year is the single rate of interest which, if used to determine the present value of the benefits taken into account in determining the plan's funding target for the year, would result in an amount equal to the plan's funding target (as determined using the first, second, and third segment rates).

*Mortality table*

Under the provision, the Secretary of the Treasury is directed to prescribe by regulation the mortality tables to be used in determining present value or making any computation under the funding rules.[447] Such tables are to be based on the actual experience of pension plans and projected trends in such experience. In prescribing tables, the Secretary is to take into account results of available independent studies of mortality of individuals covered by pension plans. In addition, the Secretary is required (at least every 10 years) to revise any table in effect to reflect the actual experience of pension plans and projected trends in such experience.

The provision also provides for the use of a separate mortality table upon request of the plan sponsor and approval by the Secretary of the Treasury in accordance with procedures described below. In order for the table to be used: (1) the table must reflect the actual experience of the pension plans maintained by the plan sponsor and projected trends in general mortality experience, and (2) there must be a sufficient number of plan participants, and the pension plans must have been maintained for a sufficient period of time, to have credible information necessary for that purpose. A separate mortality table can be a mortality table constructed by the plan's enrolled actuary from the plan's own experience or a table that is an adjustment to the table prescribed by the Secretary which sufficiently reflects the plan's experience. Except as provided by the Secretary, a separate table may not be used for any plan unless (1) a separate table is established and used for each other plan maintained by the plan sponsor and, if the plan sponsor is a member of a controlled group, each member of the controlled group,[448] and (2) the requirements for using a separate table are met with respect to the table established for each plan, taking into account only the participants of that plan, the time that plan has been in existence, and the actual experience of that plan. In general, a separate table may be used during the period of consecutive plan years (not to exceed 10) specified in the request. However, a separate mortality table ceases to be in effect as of the earlier of (1) the date on which there is a significant change in the participants in the plan by reason of a plan spinoff or merger or other-

[447] As under present law, separate mortality tables are required to be used with respect to disabled participants.

[448] For example, the Secretary may deem it appropriate to provide an exception in the case of a small plan.

wise, or (2) the date on which the plan actuary determines that the table does not meet the requirements for being used.

A plan sponsor must submit a separate mortality table to the Secretary for approval at least seven months before the first day of the period for which the table is to be used. A mortality table submitted to the Secretary for approval is treated as in effect as of the first day of the period unless the Secretary, during the 180-day period beginning on the date of the submission, disapproves of the table and provides the reasons that the table fails to meet the applicable criteria. The 180-day period is to be extended upon mutual agreement of the Secretary and the plan sponsor.

*Other assumptions*

Under the provision, in determining any present value or making any computation, the probability that future benefits will be paid in optional forms of benefit provided under the plan must be taken into account (including the probability of lump-sum distributions determined on the basis of the plan's experience and other related assumptions). The assumptions used to determine optional forms of benefit under a plan may differ from the assumptions used to determine present value for purposes of the funding rules under the provision. Differences in the present value of future benefit payments that result from the different assumptions used to determine optional forms of benefit under a plan must be taken into account in determining any present value or making any computation for purposes of the funding rules.

The provision generally does not require other specified assumptions to be used in determining the plan's target normal cost and funding target except in the case of at-risk plans (discussed below). However, similar to present law, the determination of present value or other computation must be made on the basis of actuarial assumptions and methods, each of which is reasonable (taking into account the experience of the plan and reasonable expectations), and which, in combination, offer the actuary's best estimate of anticipated experience under the plan.[449]

### *Special assumptions for at-risk plans*

The provision applies special assumptions ("at-risk" assumptions) in determining the funding target and normal cost of a plan in at-risk status. Whether a plan is in at-risk status for a plan year depends on its funding target attainment percentage for the preceding year. A plan's funding target attainment percentage for a plan year is the ratio, expressed as a percentage, that the value of the plan's assets (reduced by any funding standard carryover balance and prefunding balance) bears to the plan's funding target for the year. For this purpose, the plan's funding target is determined using the actuarial assumptions for plans that are not at-risk.

Under the provision, a plan is in at-risk status for a year if, for the preceding year: (1) the plan's funding target attainment percentage, determined without regard to the at-risk assumptions, was less than 80 percent (with a transition rule discussed below), and

[449] The provision retains the present-law rule under which certain changes in actuarial assumptions that decrease the liabilities of an underfunded single-employer plan must be approved by the Secretary of the Treasury.

(2) the plan's funding target attainment percentage, determined using the at-risk assumptions (without regard to whether the plan was in at-risk status for the preceding year), was less than 70 percent. Under a transition rule applicable for plan years beginning in 2008, 2009, and 2010, instead of 80 percent, the following percentages apply: 65 percent for 2008, 70 percent for 2009, and 75 percent for 2010. In the case of plan years beginning in 2008, the plan's funding target attainment percentage for the preceding plan year may be determined using such methods of estimation as the Secretary of Treasury may provide.

Under the provision, the at-risk rules do not apply if a plan had 500 or fewer participants on each day during the preceding plan year. For this purpose, all defined benefit pension plans (other than multiemployer plans) maintained by the same employer (or a predecessor employer), or by any member of such employer's controlled group, are treated as a single plan, but only participants with respect to such employer or controlled group member are taken into account.

If a plan is in at-risk status, the plan's funding target and normal cost are determined using the assumptions that: (1) all employees who are not otherwise assumed to retire as of the valuation date, but who will be eligible to elect benefits in the current and 10 succeeding years, are assumed to retire at the earliest retirement date under plan, but not before the end of the plan year; and (2) all employees are assumed to elect the retirement benefit available under the plan at the assumed retirement age that results in the highest present value. In some cases, a loading factor also applies.

The at-risk assumptions are not applied to certain employees of specified automobile manufacturers for purposes of determining whether a plan is in at-risk status, i.e., whether the plan's funding target attainment percentage, determined using the at-risk assumptions, was less than 70 percent for the preceding plan year. An employee is disregarded for this purpose if: (1) the employee is employed by a specified automobile manufacturer; (2) the employee is offered, pursuant to a bona fide retirement incentive program, a substantial amount of additional cash compensation, substantially enhanced retirement benefits under the plan, or materially reduced employment duties, on the condition that by a specified date no later than December 31, 2010, the employee retires (as defined under the terms of the plan); (3) the offer is made during 2006 pursuant to a bona fide retirement incentive program and requires that the offer can be accepted no later than a specified date (not later than December 31, 2006); and (4) the employee does not accept the offer before the specified date on which the offer expires. For this purpose, a specified automobile manufacturer is (1) any automobile manufacturer and (2) any manufacturer of automobile parts that supplies parts directly to an automobile manufacturer and which, after a transaction or series of transactions ending in 1999, ceased to be a member of the automobile manufacturer's controlled group.

The funding target of a plan in at-risk status for a plan year is generally the sum of: (1) the present value of all benefits accrued or earned as of the beginning of the plan year, determined using

the at-risk assumptions described above, and (2) in the case of a plan that has also been in at-risk status for at least two of the four preceding plans years, a loading factor. The loading factor is the sum of (1) $700 times the number of participants in the plan, plus (2) four percent of the funding target determined without regard to the loading factor.[450] The at-risk funding target is in no event less than the funding target determined without regard to the at-risk rules.

The target normal cost of a plan in at-risk status for a plan year is generally the sum of: (1) the present value of benefits expected to accrue or be earned under the plan during the plan year, determined using the special assumptions described above, and (2) in the case of a plan that has also been in at-risk status for at least two of the four preceding plans years, a loading factor of four percent of the target normal cost determined without regard to the loading factor.[451] The at-risk target normal cost is in no event less than at-risk normal cost determined without regard to the at-risk rules.

If a plan has been in at-risk status for fewer than five consecutive plan years, the amount of a plan's funding target for a plan year is the sum of: (1) the amount of the funding target determined without regard to the at-risk rules, plus (2) the transition percentage for the plan year of the excess of the amount of the funding target determined under the at-risk rules over the amount determined without regard to the at-risk rules. Similarly, if a plan has been in at-risk status for fewer than five consecutive plan years, the amount of a plan's target normal cost for a plan year is the sum of: (1) the amount of the target normal cost determined without regard to the at-risk rules, plus (2) the transition percentage for the plan year of the excess of the amount of the target normal cost determined under the at-risk rules over the amount determined without regard to the at-risk rules. The transition percentage is the product of 20 percent times the number of consecutive plan years for which the plan has been in at-risk status. In applying this rule, plan years beginning before 2008 are not taken into account.

### *Funding standard carryover balance or prefunding balance*

#### *In general*

The provision preserves credit balances that have accumulated under present law (referred to as "funding standard carryover balances"). In addition, for plan years beginning after 2007, new credit balances (referred to as "prefunding balances") result if an employer makes contributions greater than those required under the new funding rules. In general, under the Act, employers may choose whether to count funding standard carryover balances and prefunding balances in determining the value of plan assets or to use the balances to reduce required contributions, but not both. In

[450] This loading factor is intended to reflect the cost of purchasing group annuity contracts in the case of termination of the plan.

[451] Target normal cost for a plan in at-risk status does not include a loading factor of $700 per plan participant.

this regard, the provision provides more favorable rules with respect to the use of funding standard carryover balances.

Under the provision, if the value of a plan's assets (reduced by any prefunding balance) is at least 80 percent of the plan's funding target (determined without regard to the at-risk rules) for the preceding plan year,[452] the plan sponsor may elect to credit all or a portion of the funding standard carryover balance or prefunding balance against the minimum required contribution for the current plan year (determined after any funding waiver), thus reducing the amount that must be contributed for the current plan year.

The value of plan assets is generally reduced by any funding standard carryover balance or prefunding balance for purposes of determining minimum required contributions, including a plan's funding shortfall, and a plan's funding target attainment percentage (discussed above). However, the plan sponsor may elect to permanently reduce a funding standard carryover balance or prefunding balance, so that the value of plan assets is not required to be reduced by that amount in determining the minimum required contribution for the plan year. Any reduction of a funding standard carryover balance or prefunding balance applies before determining the balance that is available for crediting against minimum required contributions for the plan year.

*Funding standard carryover balance*

In the case of a single-employer plan that is in effect for a plan year beginning in 2007 and, as of the end of the 2007 plan year, has a positive balance in the funding standard account maintained under the funding rules as in effect for 2007, the plan sponsor may elect to maintain a funding standard carryover balance. The funding standard carryover balance consists of a beginning balance in the amount of the positive balance in the funding standard account as of the end of the 2007 plan year, decreased (as described below) and adjusted to reflect the rate of net gain or loss on plan assets.

For subsequent years (i.e., as of the first day of each plan year beginning after 2008), the funding standard carryover balance of a plan is decreased (but not below zero) by the sum of: (1) any amount credited to reduce the minimum required contribution for the preceding plan year, plus (2) any amount elected by the plan sponsor as a reduction in the funding standard carryover balance (thus reducing the amount by which the value of plan assets must be reduced in determining minimum required contributions).

*Prefunding balance*

The plan sponsor may elect to maintain a prefunding balance, which consists of a beginning balance of zero for the 2008 plan year, increased and decreased (as described below) and adjusted to reflect the rate of net gain or loss on plan assets.

For subsequent years, i.e., as of the first day of plan year beginning after 2008 (the "current" plan year), the plan sponsor may increase the prefunding balance by an amount, not to exceed (1) the excess (if any) of the aggregate total employer contributions for the

[452] In the case of plan years beginning in 2008, the percentage for the preceding plan year may be determined using such methods of estimation as the Secretary of the Treasury may provide.

preceding plan year, over (2) the minimum required contribution for the preceding plan year. For this purpose, any excess contribution for the preceding plan year is adjusted for interest accruing for the periods between the first day of the current plan year and the dates on which the excess contributions were made, determined using the effective interest rate of the plan for the preceding plan year and treating contributions as being first used to satisfy the minimum required contribution.

The amount by which the aggregate total employer contributions for the preceding plan year exceeds the minimum required contribution for the preceding plan year is reduced (but not below zero) by the amount of contributions an employer would need to make to avoid a benefit limitation that would otherwise be imposed for the preceding plan year under the provisions of the provision relating to benefit limitations for single-employer plans.[453] Thus, contributions needed to avoid a benefit limitation do not result in an increase in the plan's prefunding balance.[454]

As of the first day of each plan year beginning after 2008, the prefunding balance of a plan is decreased (but not below zero) by the sum of: (1) any amount credited to reduce the minimum required contribution for the preceding plan year, plus (2) any amount elected by the plan sponsor as a reduction in the prefunding balance (thus reducing the amount by which the value of plan assets must be reduced in determining minimum required contributions). As discussed above, if any portion of the prefunding balance is used to reduce a minimum required contribution, the value of plan assets must be reduced by the prefunding balance in determining whether a shortfall amortization base must be established for the plan year (i.e., whether the value of plan assets for a plan year is less than the plan's funding target for the plan year). Thus, the prefunding balance may not be included in the value of plan assets in order to avoid a shortfall amortization base for a plan year and also used to reduce the minimum required contribution for the same year.

*Other rules*

In determining the prefunding balance or funding standard carryover balance as of the first day of a plan year, the plan sponsor must adjust the balance in accordance with regulations prescribed by the Secretary of the Treasury to reflect the rate of return on plan assets for the preceding year. The rate of return is determined on the basis of the fair market value of the plan assets and must properly take into account, in accordance with regulations, all contributions, distributions, and other plan payments made during the period.

To the extent that a plan has a funding standard carryover balance of more than zero for a plan year, none of the plan's prefunding balance may be credited to reduce a minimum required contribution, nor may an election be made to reduce the prefunding balance for purposes of determining the value of plan assets. Thus,

[453] Any contribution that may be taken into account in satisfying the requirement to make additional contributions with respect to more than one type of benefit limitation is taken into account only once for purposes of this reduction.

[454] The benefit limitations are discussed in Part B below.

the funding standard carryover balance must be used for these purposes before the prefunding balance may be used.

Any election relating to the prefunding balance and funding standard carryover balance is to be made in such form and manner as the Secretary of the Treasury prescribes.

***Other rules and definitions***

*Valuation date*

Under the provision, all determinations made with respect to minimum required contributions for a plan year (such as the value of plan assets and liabilities) must be made as of the plan's valuation date for the plan year. In general, the valuation date for a plan year must be the first day of the plan year. However, any day in the plan year may be designated as the plan's valuation date if, on each day during the preceding plan year, the plan had 100 or fewer participants.[455] For this purpose, all defined benefit pension plans (other than multiemployer plans) maintained by the same employer (or a predecessor employer), or by any member of such employer's controlled group, are treated as a single plan, but only participants with respect to such employer or controlled group member are taken into account.

*Value of plan assets*

Under the provision, the value of plan assets is generally fair market value. However, the value of plan assets may be determined on the basis of the averaging of fair market values, but only if such method: (1) is permitted under regulations; (2) does not provide for averaging of fair market values over more than the period beginning on the last day of the 25th month preceding the month in which the plan's valuation date occurs and ending on the valuation date (or similar period in the case of a valuation date that is not the first day of a month); and (3) does not result in a determination of the value of plan assets that at any time is less than 90 percent or more than 110 percent of the fair market value of the assets at that time. Any averaging must be adjusted for contributions and distributions as provided by the Secretary of the Treasury.

If a required contribution for a preceding plan year is made after the valuation date for the current year, the contribution is taken into account in determining the value of plan assets for the current plan year. For plan years beginning after 2008, only the present value of the contribution is taken into account, determined as of the valuation date for the current plan year, using the plan's effective interest rate for the preceding plan year. In addition, any required contribution for the current plan year is not taken into account in determining the value of plan assets. If any contributions for the current plan year are made before the valuation date, plan assets as of the valuation date does not include (1) the contributions, and (2) interest on the contributions for the period between

[455] In the case of a plan's first plan year, the ability to use a valuation date other than the first day of the plan year is determined by taking into account the number of participants the plan is reasonably expected to have on each day during that first plan year.

the date of the contributions and the valuation date, determined using the plan's effective interest rate for the current plan year.

*Timing rules for contributions*

As under present law, the due date for the payment of a minimum required contribution for a plan year is generally 8½ months after the end of the plan year. Any payment made on a date other than the valuation date for the plan year must be adjusted for interest accruing at the plan's effective interest rate for the plan year for the period between the valuation date and the payment date. Quarterly contributions must be made during a plan year if the plan had a funding shortfall for the preceding plan year (that is, if the value of the plan's assets, reduced by the funding standard carryover balance and prefunding balance, was less than the plan's funding target for the preceding plan year).[456] If a quarterly installment is not made, interest applies for the period of underpayment at the rate of interest otherwise applicable (i.e., the plan's effective interest rate) plus 5 percentage points.

*Excise tax on failure to make minimum required contributions*

The provision retains the present-law rules under which an employer is generally subject to an excise tax if it fails to make minimum required contributions and fails to obtain a waiver from the IRS.[457] The excise tax is 10 percent of the aggregate unpaid minimum required contributions for all plan years remaining unpaid as of the end of any plan year. In addition, a tax of 100 percent may be imposed if any unpaid minimum required contributions remain unpaid after a certain period.

*Conforming changes*

The provision makes various technical and conforming changes to reflect the new funding requirements.

### *Effective Date*

The extension of the interest rate applicable in determining current liability for plan years beginning in 2004 and 2005 is effective for plan years beginning after December 31, 2005, and before January 1, 2008. The modifications to the single-employer plan funding rules are effective for plan years beginning after December 31, 2007.

---

[456] The provision retains the present-law rules under which the amount of any quarterly installment must be sufficient to cover any liquidity shortfall.

[457] The provision retains the present-law rules under which a lien in favor of the plan with respect to property of the employer (and members of the employer's controlled group) arises in certain circumstances in which the employer fails to make required contributions.

## B. Benefit Limitations Under Single-Employer Defined Benefit Pension Plans (secs. 103 and 113 of the Act, new secs. 101(j) and 206(g) of ERISA, and new sec. 436 of the Code)

### *Present Law*

#### *Plant shutdown and other unpredictable contingent event benefits*

A plan may provide for unpredictable contingent event benefits, which are benefits that depend on contingencies other than age, service, compensation, death or disability or that are not reliably and reasonably predictable as determined by the Secretary. Some of these benefits are commonly referred to as "plant shutdown" benefits. Under present law, unpredictable contingent event benefits generally are not taken into account for funding purposes until the event has occurred.

Defined pension plans are not permitted to provide "layoff" benefits (i.e., severance benefits).[458] However, defined benefit pension plans may provide subsidized early retirement benefits, including early retirement window benefits.[459]

#### *Limitation on certain benefit increases while funding waivers in effect*

Within limits, the IRS is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year.[460] In the case of a single-employer plan, a waiver may be granted if the employer responsible for the contribution could not make the required contribution without temporary substantial business hardship for the employer (and members of the employer's controlled group) and if requiring the contribution would be adverse to the interests of plan participants in the aggregate.

If a funding waiver is in effect for a plan, subject to certain exceptions, no plan amendment may be adopted that increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits vest under the plan.[461]

#### *Security for certain plan amendments*

In the case of a single-employer defined benefit pension plan, if a plan amendment increasing current liability is adopted and the plan's funded current liability percentage is less than 60 percent (taking into account the effect of the amendment, but disregarding any unamortized unfunded old liability), the employer and members of the employer's controlled group must provide security in favor of the plan.[462] The amount of security required is the excess of: (1) the lesser of (a) the amount by which the plan's assets are less than 60 percent of current liability, taking into account the benefit increase, or (b) the amount of the benefit increase and prior

[458] Treas. Reg. sec. 1.401–1(b)(1)(i).
[459] See, e.g., Treas. Reg. secs. 1.401(a)(4)–3(f)(4) and 1.411(a)–7(c).
[460] Code sec. 412(d); ERISA sec. 303.
[461] Code sec. 412(f); ERISA sec. 304(b)(1).
[462] Code sec. 401(a)(29); ERISA sec. 307.

benefit increases after December 22, 1987, over (2) $10 million. The amendment is not effective until the security is provided.

The security must be in the form of a surety bond, cash, certain U.S. government obligations, or such other form as is satisfactory to the Secretary of the Treasury and the parties involved. The security is released after the funded liability of the plan reaches 60 percent.

### *Prohibition on benefit increases during bankruptcy*

Subject to certain exceptions, if an employer maintaining a single-employer defined benefit pension plan is involved in bankruptcy proceedings, no plan amendment may be adopted that increases the liabilities of the plan by reason of any increase in benefits, or any change in the accrual of benefits, or any change in the rate at which benefits vest under the plan.[463] This limitation does not apply if the plan's funded current liability percentage is at least 100 percent, taking into account the amendment.

### *Restrictions on benefit payments due to liquidity shortfalls*

In the case of a single-employer plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year. If quarterly contributions are required with respect to a plan, the amount of a quarterly installment must also be sufficient to cover any shortfall in the plan's liquid assets (a "liquidity shortfall"). In general, a plan has a liquidity shortfall for a quarter if the plan's liquid assets (such as cash and marketable securities) are less than a certain amount (generally determined by reference to disbursements from the plan in the preceding 12 months).

If a quarterly installment is less than the amount required to cover the plan's liquidity shortfall, limits apply to the benefits that can be paid from a plan during the period of underpayment. During that period, the plan may not make any prohibited payment, defined as: (1) any payment in excess of the monthly amount paid under a single life annuity (plus any social security supplement provided under the plan) to a participant or beneficiary whose annuity starting date occurs during the period; (2) any payment for the purchase of an irrevocable commitment from an insurer to pay benefits (e.g., an annuity contract); or (3) any other payment specified by the Secretary of the Treasury by regulations.[464]

## *Explanation of Provision*

### *Plant shutdown and other unpredictable contingent event benefits*

Under the provision, if a participant is entitled to an unpredictable contingent event benefit payable with respect to any event occurring during any plan year, the plan must provide that such benefits may not be provided if the plan's adjusted funding target attainment percentage for that plan year: (1) is less than 60 percent; or (2) would be less than 60 percent taking into account the occur-

[463] Code sec. 401(a)(33); ERISA sec. 204(i).
[464] Code sec. 401(a)(32); ERISA sec. 206(e).

rence of the event. For this purpose, the term unpredictable contingent event benefit means any benefit payable solely by reason of: (1) a plant shutdown (or similar event, as determined by the Secretary of the Treasury); or (2) any event other than attainment of any age, performance of any service, receipt or derivation of any compensation, or the occurrence of death or disability.

The determination of whether the limitation applies is made in the year the unpredictable contingent event occurs. For example, suppose a plan provides for benefits upon the occurrence of a plant shutdown, and a plant shutdown occurs in 2010. Taking into account the plant shutdown, the plan's adjusted funding target attainment percentage is less than 60 percent. Thus, the limitation applies, and benefits payable solely by reason of the plant shutdown may not be paid (unless the employer makes contributions to the plan as described below), regardless of whether the benefits will be paid in the 2010 plan year or a later plan year.[465]

The limitation ceases to apply with respect to any plan year, effective as of the first day of the plan year, if the plan sponsor makes a contribution (in addition to any minimum required contribution for the plan year) equal to: (1) if the plan's adjusted funding target attainment percentage is less than 60 percent, the amount of the increase in the plan's funding target for the plan year attributable to the occurrence of the event; or (2) if the plan's adjusted funding target attainment percentage would be less than 60 percent taking into account the occurrence of the event, the amount sufficient to result in a adjusted funding target attainment percentage of 60 percent.

The limitation does not apply for the first five years a plan (or a predecessor plan) is in effect.

### *Plan amendments increasing benefit liabilities*

Certain plan amendments may not take effect during a plan year if the plan's adjusted funding target attainment percentage for the plan year: (1) is less than 80 percent; or (2) would be less than 80 percent taking into account the amendment.[466] In such a case, no amendment may take effect if it has the effect of increasing the liabilities of the plan by reason of any increase in benefits, the establishment of new benefits, any change in the rate of benefit accrual, or any change in the rate at which benefits vest under the plan. The limitation does not apply to an amendment that provides for an increase in benefits under a formula which is not based on compensation, but only if the rate of increase does not exceed the contemporaneous rate of increase in average wages of the participants covered by the amendment.

The limitation ceases to apply with respect to any plan year, effective as of the first day of the plan year (or, if later, the effective date of the amendment), if the plan sponsor makes a contribution (in addition to any minimum required contribution for the plan year) equal to: (1) if the plan's adjusted funding target attainment percentage is less than 80 percent, the amount of the increase in

[465] Benefits already being paid as a result of a plant shutdown or other event that occurred in a preceding year are not affected by the limitation.

[466] Under the provision, the present-law rules limiting benefit increases while an employer is in bankruptcy continue to apply.

the plan's funding target for the plan year attributable to the amendment; or (2) if the plan's adjusted funding target attainment percentage would be less than 80 percent taking into account the amendment, the amount sufficient to result in a adjusted funding target attainment percentage of 80 percent.

The limitation does not apply for the first five years a plan (or a predecessor plan) is in effect.

***Prohibited payments***

A plan must provide that, if the plan's adjusted funding target attainment percentage for a plan year is less than 60 percent, the plan will not make any prohibited payments after the valuation date for the plan year.

A plan must also provide that, if the plan's adjusted funding target attainment percentage for a plan year is 60 percent or greater, but less than 80 percent, the plan may not pay any prohibited payments exceeding the lesser of: (1) 50 percent of the amount otherwise payable under the plan, and (2) the present value of the maximum PBGC guarantee with respect to the participant (determined under guidance prescribed by the PBGC, using the interest rates and mortality table applicable in determining minimum lump-sum benefits). The plan must provide that only one payment under this exception may be made with respect to any participant during any period of consecutive plan years to which the limitation applies. For this purpose, a participant and any beneficiary of the participant (including an alternate payee) is treated as one participant. If the participant's accrued benefit is allocated to an alternate payee and one or more other persons, the amount that may be distributed is allocated in the same manner unless the applicable qualified domestic relations order provides otherwise.

In addition, a plan must provide that, during any period in which the plan sponsor is in bankruptcy proceedings, the plan may not pay any prohibited payment. However, this limitation does not apply on or after the date the plan's enrolled actuary certifies that the adjusted funding target attainment percentage of the plan is not less than 100 percent.

For purposes of these limitations, "prohibited payment" is defined as under the present-law rule restricting distributions during a period of a liquidity shortfall and means (1) any payment in excess of the monthly amount paid under a single life annuity (plus any social security supplement provided under the plan) to a participant or beneficiary whose annuity starting date occurs during the period, (2) any payment for the purchase of an irrevocable commitment from an insurer to pay benefits (e.g., an annuity contract), or (3) any other payment specified by the Secretary of the Treasury by regulations.

The prohibited payment limitation does not apply to a plan for any plan year if the terms of the plan (as in effect for the period beginning on September 1, 2005, and ending with the plan year) provide for no benefit accruals with respect to any participant during the period.

### *Cessation of benefit accruals*

A plan must provide that, if the plan's adjusted funding target attainment percentage is less than 60 percent for a plan year, all future benefit accruals under the plan must cease as of the valuation date for the plan year. The limitation applies only for purposes of the accrual of benefits; service during the freeze period is counted for other purposes. For example, if accruals are frozen under the provision, service earned during the freeze period still counts for vesting purposes. Or, as another example, suppose a plan provides that payment of benefits begins when a participant terminates employment after age 55 and with 25 years of service. Under this example, if a participant who is age 55 and has 23 years of service when the freeze on accruals becomes applicable terminates employment two years later, the participant has 25 years of service for this purpose and thus can begin receiving benefits. However (assuming the freeze on accruals is still in effect), the amount of the benefit is based on the benefit accrued before the freeze (i.e., counting only 23 years of service).

The limitation ceases to apply with respect to any plan year, effective as of the first day of the plan year, if the plan sponsor makes a contribution (in addition to any minimum required contribution for the plan year) equal to the amount sufficient to result in an adjusted funding target attainment percentage of 60 percent.

The limitation does not apply for the first five years a plan (or a predecessor plan) is in effect.

### *Adjusted funding target attainment percentage*

#### *In general*

The term "funding target attainment percentage" is defined as under the minimum funding rules, i.e., the ratio, expressed as a percentage, that the value of the plan's assets (reduced by any funding standard carryover balance and prefunding balance) bears to the plan's funding target for the year (determined without regard to at-risk status). A plan's adjusted funding target attainment percentage is determined in the same way, except that the value of the plan's assets and the plan's funding target are both increased by the aggregate amount of purchases of annuities for employees other than highly compensated employees made by the plan during the two preceding plan years.

#### *Special rule for fully funded plans*

Under a special rule, if a plan's funding target attainment percentage is at least 100 percent, determined by not reducing the value of the plan's assets by any funding standard carryover balance or prefunding balance, the value of the plan's assets is not so reduced in determining the plan's funding target attainment percentage for purposes of whether the benefit limitations apply. Under a transition rule for a plan year beginning after 2007 and before 2011, the "applicable percentage" for the plan year is substituted for 100 percent in applying the special rule. For this purpose, the applicable percentage is 92 percent for 2008, 94 percent for 2009, and 96 percent for 2010. However, for any plan year beginning after 2008, the transition rule does not apply unless the

plan's funding target attainment percentage (determined by not reducing the value of the plan's assets by any funding standard carryover balance or prefunding balance) for each preceding plan year in the transition period is at least equal to the applicable percentage for the preceding year.

*Presumptions as to funded status*

Under the provision, certain presumptions apply in determining whether limitations apply with respect to a plan, subject to certification of the plan's adjusted funding target attainment percentage by the plan's enrolled actuary.

If a plan was subject to a limitation for the preceding year, the plan's adjusted funding target attainment percentage for the current year is presumed to be the same as for the preceding year until the plan actuary certifies the plan's actual adjusted funding target attainment percentage for the current year.

If (1) a plan was not subject to a limitation for the preceding year, but its adjusted funding target attainment percentage for the preceding year was not more than 10 percentage points greater than the threshold for a limitation, and (2) as of the first day of the fourth month of the current plan year, the plan actuary has not certified the plan's actual adjusted funding target attainment percentage for the current year, the plan's funding target attainment percentage is presumed to be reduced by 10 percentage points as of that day and that day is deemed to be the plan's valuation date for purposes of applying the benefit limitation. As a result, the limitation applies as of that date until the actuary certifies the plan's actual adjusted funding target attainment percentage.

In any other case, if the plan actuary has not certified the plan's actual adjusted funding target attainment percentage by the first day of the tenth month of the current plan year, for purposes of the limitations, the plan's adjusted funding target attainment percentage is conclusively presumed to be less than 60 percent as of that day and that day is deemed to be the valuation date for purposes of applying the benefit limitations.[467]

### *Reduction of funding standard carryover and prefunding balances*

*Election to reduce balances*

As discussed above, the value of plan assets is generally reduced by any funding standard carryover or prefunding in determining a plan's funding target attainment percentage. As provided for under the funding rules applicable to single-employer plans, a plan sponsor may elect to reduce a funding standard carryover balance or prefunding balance, so that the value of plan assets is not required to be reduced by that amount in determining the plan's funding target attainment percentage.

[467] For purposes of applying the presumptions to plan years beginning in 2008, the funding target attainment percentage for the preceding year may be determined using such methods of estimation as the Secretary of the Treasury may provide.

*Deemed reduction of balances in the case of collectively bargained plans*

If a benefit limitation would otherwise apply to a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers, the plan sponsor is treated as having made an election to reduce any prefunding balance or funding standard carryover balance by the amount necessary to prevent the benefit limitation from applying. However, the employer is not treated as having made such an election if the election would not prevent the benefit limitation from applying to the plan.

*Deemed reduction of balances in the case of other plans*

If the prohibited payment limitation would otherwise apply to a plan that is not maintained pursuant to a collective bargaining agreement, the plan sponsor is treated as having made an election to reduce any prefunding balance or funding standard carryover balance by the amount necessary to prevent the benefit limitation from applying. However, the employer is not treated as having made such an election if the election would not prevent the benefit limitation from applying to the plan.

***Contributions made to avoid a benefit limitation***

Under the provision, an employer may make contributions (in addition to any minimum required contribution) in an amount sufficient to increase the plan's adjusted funding target attainment percentage to a level to avoid a limitation on unpredictable contingent event benefits, a plan amendment increasing benefits, or additional accruals. An employer may not use a prefunding balance or funding standard carryover balance in lieu of such a contribution, and such a contribution does not result in an increase in any prefunding balance.

Instead of making additional contributions to avoid a benefit limitation, an employer may provide security in the form of a surety bond, cash, certain U.S. government obligations, or such other form as is satisfactory to the Secretary of the Treasury and the parties involved. In such a case, the plan's adjusted funding target attainment percentage is determined by treating the security as a plan asset. Any such security may be perfected and enforced at any time after the earlier of: (1) the date on which the plan terminates; (2) if the plan sponsor fails to make a required contribution for any subsequent plan year, the due date for the contribution; or (3) if the plan's adjusted funding target attainment percentage is less than 60 percent for a consecutive period of seven years, the valuation date for the last year in the period. The security will be released (and any related amounts will be refunded with any accrued interest) at such time as the Secretary of the Treasury may prescribe in regulations (including partial releases by reason of increases in the plan's funding target attainment percentage).

***Treatment of plan as of close of prohibited or cessation period***

Under the provision, if a limitation on prohibited payments or future benefit accruals ceases to apply to a plan, all such payments

and benefit accruals resume, effective as of the day following the close of the period for which the limitation applies.[468] Nothing in this rule is to be construed as affecting a plan's treatment of benefits which would have been paid or accrued but for the limitation.

***Notice to participants***

The plan administrator must provide written notice to participants and beneficiaries within 30 days: (1) after the plan has become subject to the limitation on unpredictable uncontingent event benefits or prohibited payments; (2) in the case of a plan to which the limitation on benefit accruals applies, after the valuation date for the plan year in which the plan's adjusted target attainment percentage is less than 60 percent (or, if earlier, the date the adjusted target attainment percentage is deemed to be less than 60 percent). Notice must also be provided at such other times as may be determined by the Secretary of the Treasury. The notice may be in electronic or other form to the extent such form is reasonably accessible to the recipient.

If the plan administrator fails to provide the required notice, the Secretary of Labor may impose a civil penalty of up to $1,000 a day from the time of the failure.

***Effective Date***

The provision generally applies with respect to plan years beginning after December 31, 2007.

In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before January 1, 2008, the provision does not apply to plan years beginning before the earlier of: (1) the later of (a) the date on which the last collective bargaining agreement relating to the plan terminates (determined without regard to any extension thereof agreed to after the date of enactment (August 17, 2006)), or (b) the first day of the first plan year to which the provision would otherwise apply; or (2) January 1, 2010. For this purpose, any plan amendment made pursuant to a collective bargaining agreement relating to the plan that amends the plan solely to conform to any requirement under the provision is not to be treated as a termination of the collective bargaining agreement.

## C. Special Rules for Multiple-Employer Plans of Certain Cooperatives (sec. 104 of the Act)

### *Present Law*

Defined benefit pension plans are required to meet certain minimum funding rules. In some cases, additional contributions are required under the deficit reduction contribution rules if a single-employer defined benefit pension plan is underfunded. Additional contributions generally are not required in the case of a plan with a funded current liability percentage of at least 90 percent. A plan's funded current liability percentage is the value of plan assets as a

[468] This rule does not apply to limitations on unpredictable contingent event benefits and plan amendments increasing liabilities.

percentage of current liability. In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan, determined using specified interest and mortality assumptions. In the case of a plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year.

The PBGC insures benefits under most single-employer defined benefit pension plans in the event the plan is terminated with insufficient assets to pay for plan benefits. The PBGC is funded in part by a flat-rate premium per plan participant, and variable-rate premiums based on the amount of unfunded vested benefits under the plan. A specified interest rate and a specified mortality table apply in determining unfunded vested benefits for this purpose.

A multiple-employer plan is a plan that is maintained by more than one employer and is not maintained pursuant to a collective bargaining agreement.[469] A multiple-employer plan is subject to the minimum funding rules for single-employer plans and to PBGC variable-rate premiums.

### *Explanation of Provision*

The provision provides a delayed effective date for the new single-employer plan funding rules in the case of a plan that was in existence on July 26, 2005, and was an eligible cooperative plan for the plan year including that date. The new funding rules do not apply with respect to such a plan for plan years beginning before the earlier of: (1) the first plan year for which the plan ceases to be an eligible cooperative plan, or (2) January 1, 2017. In addition, in applying the present-law funding rules to an eligible cooperative plan to such a plan for plan years beginning after December 31, 2007, and before the first plan year for which the new funding rules apply, the interest rate used is the interest rate applicable under the new funding rules with respect to payments expected to be made from the plan after the 20-year period beginning on the first day of the plan year (i.e., the third segment rate under the new funding rules).

A plan is treated as an eligible cooperative plan for a plan year if it is maintained by more than one employer and at least 85 percent of the employers are: (1) certain rural cooperatives;[470] or (2) certain cooperative organizations that are more than 50-percent owned by agricultural producers or by cooperatives owned by agricultural producers, or organizations that are more than 50-percent owned, or controlled by, one or more such cooperative organizations. A plan is also treated as an eligible cooperative plan for any plan year for which it is maintained by more than one employer and is maintained by a rural telephone cooperative association.

---

[469] A plan maintained by more than one employer pursuant to a collective bargaining agreement is referred to as a multiemployer plan.

[470] This is as defined in Code section 401(k)(7)(B) without regard to (iv) thereof and includes (1) organizations engaged primarily in providing electric service on a mutual or cooperative basis, or engaged primarily in providing electric service to the public in its service area and which is exempt from tax or which is a State or local government, other than a municipality; (2) certain civic leagues and business leagues exempt from tax 80 percent of the members of which are described in (1); (3) certain cooperative telephone companies; and (4) any organization that is a national association of organizations described above.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## D. Temporary Relief for Certain PBGC Settlement Plans (sec. 105 of the Act)

### *Present Law*

Defined benefit pension plans are required to meet certain minimum funding rules. In some cases, additional contributions are required under the deficit reduction contribution rules if a single-employer defined benefit pension plan is underfunded. Additional contributions generally are not required in the case of a plan with a funded current liability percentage of at least 90 percent. A plan's funded current liability percentage is the value of plan assets as a percentage of current liability. In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan, determined using specified interest and mortality assumptions. In the case of a plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year.

The PBGC insures benefits under most single-employer defined benefit pension plans in the event the plan is terminated with insufficient assets to pay for plan benefits. The PBGC is funded in part by a flat-rate premium per plan participant, and variable-rate premiums based on the amount of unfunded vested benefits under the plan. A specified interest rate and a specified mortality table apply in determining unfunded vested benefits for this purpose.

### *Explanation of Provision*

The provision agreement provides a delayed effective date for the new single-employer plan funding rules in the case of a plan that was in existence on July 26, 2005, and was a "PBGC settlement plan" as of that date. The new funding rules do not apply with respect to such a plan for plan years beginning before January 1, 2014. In addition, in applying the present-law funding rules to a such a plan for plan years beginning after December 31, 2007, and before January 1, 2014, the interest rate used is the interest rate applicable under the new funding rules with respect to payments expected to be made from the plan after the 20-year period beginning on the first day of the plan year (i.e., the third segment rate under the new funding rules).

Under the provision, the term "PBGC settlement plan" means a single-employer defined benefit plan: (1) that was sponsored by an employer in bankruptcy proceedings giving rise to a claim by the PBGC of not greater than $150 million, and the sponsorship of which was assumed by another employer (not a member of the same controlled group as the bankrupt sponsor) and the PBGC's claim was settled or withdrawn in connection with the assumption of the sponsorship; or (2) that, by agreement with the PBGC, was spun off from a plan subsequently terminated by the PBGC in an involuntary termination.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## E. Special Rules for Plans of Certain Government Contractors (sec. 106 of the Act)

### *Present Law*

Defined benefit pension plans are required to meet certain minimum funding rules. In some cases, additional contributions are required under the deficit reduction contribution rules if a single-employer defined benefit pension plan is underfunded. Additional contributions generally are not required in the case of a plan with a funded current liability percentage of at least 90 percent. A plan's funded current liability percentage is the value of plan assets as a percentage of current liability. In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan, determined using specified interest and mortality assumptions. In the case of a plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year.

The PBGC insures benefits under most single-employer defined benefit pension plans in the event the plan is terminated with insufficient assets to pay for plan benefits. The PBGC is funded in part by a flat-rate premium per plan participant, and variable-rate premiums based on the amount of unfunded vested benefits under the plan. A specified interest rate and a specified mortality table apply in determining unfunded vested benefits for this purpose.

### *Explanation of Provision*

The provision provides a delayed effective date for the new single-employer plan funding rules in the case of an eligible government contractor plan. The new funding rules do not apply with respect to such a plan for plan years beginning before the earliest of: (1) the first plan year for which the plan ceases to be an eligible government contractor plan, (2) the effective date of the Cost Accounting Standards Pension Harmonization Rule, and (3) the first plan year beginning after December 31, 2010. In addition, in applying the present-law funding rules to a such a plan for plan years beginning after December 31, 2007, and before the first plan year for which the new funding rules apply, the interest rate used is the interest rate applicable under the new funding rules with respect to payments expected to be made from the plan after the 20-year period beginning on the first day of the plan year (i.e., the third segment rate under the new funding rules).

Under the provision, a plan is treated as an eligible government contractor plan if it is maintained by a corporation (or member of the same affiliated group): (1) whose primary source of revenue is derived from business performed under contracts with the United States that are subject to the Federal Acquisition Regulations and also to the Defense Federal Acquisition Regulation Supplement; (2) whose revenue derived from such business in the previous fiscal

year exceeded $5 billion; and (3) whose pension plan costs that are assignable under those contracts are subject to certain provisions of the Cost Accounting Standards.

The provision also requires the Cost Accounting Standards Board, not later than January 1, 2010, to review and revise the relevant provisions of the Cost Accounting Standards to harmonize minimum contributions required under ERISA of eligible government contractor plans and government reimbursable pension plan costs. Any final rule adopted by the Cost Accounting Standards Board shall be deemed the Cost Accounting Standards Pension Harmonization Rule.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## F. Modification of Transition Rule to Pension Funding Requirements for Interstate Bus Company (sec. 115 of the Act, and sec. 769(c) of the Retirement Protection Act, as added by sec. 1508 of the Taxpayer Relief Act of 1997)

### *Present Law*

Defined benefit pension plans are required to meet certain minimum funding rules. In some cases, additional contributions are required under the deficit reduction contribution rules if a single-employer defined benefit pension plan is underfunded. Additional contributions generally are not required in the case of a plan with a funded current liability percentage of at least 90 percent. A plan's funded current liability percentage is the value of plan assets as a percentage of current liability. In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan, determined using specified interest and mortality assumptions. In the case of a plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year.

The PBGC insures benefits under most single-employer defined benefit pension plans in the event the plan is terminated with insufficient assets to pay for plan benefits. The PBGC is funded in part by a flat-rate premium per plan participant, and variable rate premiums based on the amount of unfunded vested benefits under the plan. A specified interest rate and a specified mortality table apply in determining unfunded vested benefits for this purpose.

A special rule modifies the minimum funding requirements in the case of certain plans. The special rule applies in the case of plans that: (1) were not required to pay a variable rate PBGC premium for the plan year beginning in 1996; (2) do not, in plan years beginning after 1995 and before 2009, merge with another plan (other than a plan sponsored by an employer that was a member of the controlled group of the employer in 1996); and (3) are sponsored by a company that is engaged primarily in interurban or interstate passenger bus service.

The special rule generally treats a plan to which it applies as having a funded current liability percentage of at least 90 percent for plan years beginning after 1996 and before 2004 if for such plan year the funded current liability percentage is at least 85 percent. If the funded current liability of the plan is less than 85 percent for any plan year beginning after 1996 and before 2004, the relief from the minimum funding requirements generally applies only if certain specified contributions are made.

For plan years beginning in 2004 and 2005, the funded current liability percentage of the plan is treated as at least 90 percent for purposes of determining the amount of required contributions (100 percent for purposes of determining whether quarterly contributions are required). As a result, for these years, additional contributions under the deficit reduction contribution rules and quarterly contributions are not required with respect to the plan. In addition, for these years, the mortality table used under the plan is used in calculating PBGC variable rate premiums.

For plan years beginning after 2005 and before 2010, the funded current liability percentage generally will be deemed to be at least 90 percent if the actual funded current liability percentage is at least at certain specified levels. The relief from the minimum funding requirements generally applies for a plan year beginning in 2006, 2007, or 2008 only if contributions to the plan for the plan year equal at least the expected increase in current liability due to benefits accruing during the plan year.

### *Explanation of Provision*

The provision revises the special rule for a plan that is sponsored by a company engaged primarily in interurban or interstate passenger bus service and that meets the other requirements for the special rule under present law. The provision extends the application of the special rule under present law for plan years beginning in 2004 and 2005 to plan years beginning in 2006 and 2007. The provision also provides several special rules relating to determining minimum required contributions and variable rate premiums for plan years beginning after 2007 when the new funding rules for single-employer plans apply.

Under the provision, for the plan year beginning in 2006 or 2007, a plan's funded current liability percentage of a plan is treated as at least 90 percent for purposes of determining the amount of required contributions (100 percent for purposes of determining whether quarterly contributions are required). As a result, for the 2006 and 2007 plan years, additional contributions under the deficit reduction contribution rules and quarterly contributions are not required with respect to the plan. In addition, the mortality table used under the plan is used in calculating PBGC variable rate premiums.

Under the provision, for plan years beginning after 2007, the mortality table used under the plan is used in: (1) determining any present value or making any computation under the minimum funding rules applicable to the plan; and (2) calculating PBGC variable rate premiums. Under a special phase-in (in lieu of the phase-in otherwise applicable under the provision relating to funding rules for single-employer plans), for purposes of determining

whether a shortfall amortization base is required for plan years beginning after 2007 and before 2012, the applicable percentage of the plan's funding shortfall is the following: 90 percent for 2008, 92 percent for 2009, 94 percent for 2010, and 96 percent for 2011. In addition, for purposes of the quarterly contributions requirement, the plan is treated as not having a funding shortfall for any plan year. As a result, quarterly contributions are not required with respect to the plan.

### *Effective Date*

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

## G. Restrictions on Funding of Nonqualified Deferred Compensation Plans by Employers Maintaining Underfunded or Terminated Single-Employer Plans (sec. 116 of the Act and sec. 409A of the Code)

### *Present Law*

Amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied.[471] For example, distributions from a nonqualified deferred compensation plan may be allowed only upon certain times and events. Rules also apply for the timing of elections. If the requirements are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.

In the case of assets set aside in a trust (or other arrangement) for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under Code section 83 at the time set aside if such assets (or trust or other arrangement) are located outside of the United States or at the time transferred if such assets (or trust or other arrangement) are subsequently transferred outside of the United States. A transfer of property in connection with the performance of services under Code section 83 also occurs with respect to compensation deferred under a nonqualified deferred compensation plan if the plan provides that upon a change in the employer's financial health, assets will be restricted to the payment of nonqualified deferred compensation.

[471] Code sec. 409A.

### *Explanation of Provision*

Under the provision, if during any restricted period in which a defined benefit pension plan of an employer is in at-risk status,[472] assets are set aside (directly or indirectly) in a trust (or other arrangement as determined by the Secretary of the Treasury), or transferred to such a trust or other arrangement, for purposes of paying deferred compensation of an applicable covered employee, such transferred assets are treated as property transferred in connection with the performance of services (whether or not such assets are available to satisfy the claims of general creditors) under Code section 83. The rule does not apply in the case of assets that are set aside before the defined benefit pension plan is in at-risk status.

If a nonqualified deferred compensation plan of an employer provides that assets will be restricted to the provision of benefits under the plan in connection with a restricted period (or other similar financial measure determined by the Secretary of Treasury) of any defined benefit pension plan of the employer, or assets are so restricted, such assets are treated as property transferred in connection with the performance of services (whether or not such assets are available to satisfy the claims of general creditors) under Code section 83.

A restricted period is (1) any period in which a single-employer defined benefit pension plan of an employer is in at risk-status, (2) any period in which the employer is in bankruptcy, and (3) the period that begins six months before and ends six months after the date any defined benefit pension plan of the employer is terminated in an involuntary or distress termination. The provision does not apply with respect to assets set aside before a restricted period.

In general, applicable covered employees include the chief executive officer (or individual acting in such capacity), the four highest compensated officers for the taxable year (other than the chief executive officer), and individuals subject to section 16(a) of the Securities Exchange Act of 1934. An applicable covered employee includes any (1) covered employee of a plan sponsor; (2) covered employee of a member of a controlled group which includes the plan sponsor; and (3) former employee who was a covered employee at the time of termination of employment with the plan sponsor or a member of a controlled group which includes the plan sponsor.

A nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE.[473] A qualified governmental excess benefit arrangement (sec. 415(m)) is a qualified employer plan. An eligible deferred compensation plan (sec. 457(b))

---

[472] At-risk status is defined as under the provision relating to funding rules for single-employer defined benefit pension plans. Under those rules, in general, a plan is in at-risk for a year if, for the preceding year: (1) the plan's funding target attainment percentage, determined without regard to the at-risk assumptions, was less than 80 percent, and (2) the plan's funding target attainment percentage, determined using the at-risk assumptions (without regard to whether the plan was in at-risk status for the preceding year), was less than 70 percent.

[473] A qualified employer plan also includes a section 501(c)(18) trust.

is also a qualified employer plan under the provision. The term plan includes any agreement or arrangement, including an agreement or arrangement that includes one person.

Any subsequent increases in the value of, or any earnings with respect to, transferred or restricted assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to an additional 20-percent tax.

Under the provision, if an employer provides directly or indirectly for the payment of any Federal, State or local income taxes with respect to any compensation required to be included in income under the provision, interest is imposed on the amount of such payment in the same manner as if the payment were part of the deferred compensation to which it related. As under present law, such payment is included in income; in addition, under the provision, such payment is subject to a 20 percent additional tax. The payment is also nondeductible by the employer.

### *Effective Date*

The provision is effective for transfers or other reservations of assets after date of enactment (August 17, 2006).

## TITLE II—FUNDING RULES FOR MULTIEMPLOYER DEFINED BENEFIT PLANS

### A. Funding Rules for Multiemployer Defined Benefit Plans (secs. 201 and 211 of the Act, new sec. 304 of ERISA, and new sec. 431 of the Code)

#### *Present Law*

***Multiemployer plans***

A multiemployer plan is a plan to which more than one unrelated employer contributes, which is established pursuant to one or more collective bargaining agreements, and which meets such other requirements as specified by the Secretary of Labor. Multiemployer plans are governed by a board of trustees consisting of an equal number of employer and employee representatives. In general, the level of contributions to a multiemployer plan is specified in the applicable collective bargaining agreements, and the level of plan benefits is established by the plan trustees.

Defined benefit multiemployer plans are subject to the same general minimum funding rules as single-employer plans, except that different rules apply in some cases. For example, different amortization periods apply for some costs in the case of multiemployer plans. In addition, the deficit reduction contribution rules do not apply to multiemployer plans.

***Funding standard account***

As an administrative aid in the application of the funding requirements, a defined benefit pension plan is required to maintain a special account called a "funding standard account" to which specified charges and credits are made for each plan year, including a charge for normal cost and credits for contributions to the plan. Other credits or charges or credits may apply as a result of decreases or increases in past service liability as a result of plan amendments or experience gains or losses, gains or losses resulting from a change in actuarial assumptions, or a waiver of minimum required contributions.

If, as of the close of the plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an "accumulated funding deficiency." For example, if the balance of charges to the funding standard account of a plan for a year would be $200,000 without any contributions, then a minimum contribution equal to that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency. If credits to the funding standard account exceed charges, a "credit balance" results. The amount of the credit balance, increased with interest, can be used to reduce future required contributions.

***Funding methods and general concepts***

*In general*

A defined benefit pension plan is required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as: (1) normal cost; and (2) supplemental cost.

*Normal cost*

The plan's normal cost for a plan year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. Specifically, it is the amount actuarially determined that would be required as a contribution by the employer for the plan year in order to maintain the plan if the plan had been in effect from the beginning of service of the included employees and if the costs for prior years had been paid, and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled.

*Supplemental cost*

The supplemental cost for a plan year is the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets. The most common supplemental cost is that attributable to past service liability, which represents the cost of future benefits under the plan: (1) on the date the plan is first effective; or (2) on the date a plan amendment increasing plan benefits is first effective. Other supplemental costs may be attributable to net experience losses, changes in actuarial assumptions, and amounts necessary to make up funding deficiencies for which a waiver was obtained. Supplemental costs must be amortized (i.e., recognized for funding purposes) over a specified number of years, depending on the source.

*Valuation of assets*

For funding purposes, the actuarial value of plan assets may be used, rather than fair market value. The actuarial value of plan assets is the value determined under a reasonable actuarial valuation method that takes into account fair market value and is permitted under Treasury regulations. Any actuarial valuation method used must result in a value of plan assets that is not less than 80 percent of the fair market value of the assets and not more than 120 percent of the fair market value. In addition, if the valuation method uses average value of the plan assets, values may be used for a stated period not to exceed the five most recent plan years, including the current year.

*Reasonableness of assumptions*

In applying the funding rules, all costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods, each of which is reasonable (tak-

ing into account the experience of the plan and reasonable expectations), or which, in the aggregate, result in a total plan contribution equivalent to a contribution that would be obtained if each assumption and method were reasonable. In addition, the assumptions are required to offer the actuary's best estimate of anticipated experience under the plan.

***Charges and credits to the funding standard account***

*In general*

Under the minimum funding standard, the portion of the cost of a plan that is required to be paid for a particular year depends upon the nature of the cost. For example, the normal cost for a year is generally required to be funded currently. Other costs are spread (or amortized) over a period of years. In the case of a multiemployer plan, past service liability is amortized over 40 or 30 years depending on how the liability arose, experience gains and losses are amortized over 15 years, gains and losses from changes in actuarial assumptions are amortized over 30 years, and waived funding deficiencies are amortized over 15 years.

*Normal cost*

Each plan year, a plan's funding standard account is charged with the normal cost assigned to that year under the particular acceptable actuarial cost method adopted by the plan. The charge for normal cost will require an offsetting credit in the funding standard account. Usually, an employer contribution is required to create the credit. For example, if the normal cost for a plan year is $150,000, the funding standard account would be charged with that amount for the year. Assuming that there are no other credits in the account to offset the charge for normal cost, an employer contribution of $150,000 will be required for the year to avoid an accumulated funding deficiency.

*Past service liability*

There are three separate charges to the funding standard account one or more of which may apply to a multiemployer plan as the result of past service liabilities. In the case of a plan in existence on January 1, 1974, past service liability under the plan on the first day on which the plan was first subject to ERISA is amortized over 40 years. In the case of a plan which was not in existence on January 1, 1974, past service liability under the plan on the first day on which the plan was first subject to ERISA is amortized over 30 years. Past service liability due to plan amendments is amortized over 30 years.

*Experience gains and losses*

In determining plan funding under an actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. The actuarial assumptions are required to be reasonable, as discussed above. If the plan's actual unfunded liabilities are less than those antici-

pated by the actuary on the basis of these assumptions, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. In the case of a multiemployer plan, experience gains and losses for a year are generally amortized over a 15-year period, resulting in credits or charges to the funding standard account.

*Gains and losses from changes in assumptions*

If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from changes in actuarial assumptions. If the new assumptions result in an increase in the accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost or future employee contributions. In the case of a multiemployer plan, the gain or loss for a year from changes in actuarial assumptions is amortized over a period of 30 years, resulting in credits or charges to the funding standard account.

***Shortfall funding method***

Certain plans may elect to determine the required charges to the funding standard account under the shortfall method. Under such method, the charges are computed on the basis of an estimated number of units of service or production for which a certain amount per unit is to be charged. The difference between the net amount charged under this method and the net amount that otherwise would have been charged for the same period is a shortfall loss or gain that is amortized over subsequent plan years. The use of the shortfall method and changes to use of the shortfall method are generally subject to IRS approval.

***Funding waivers and amortization of waived funding deficiencies***

Within limits, the Secretary of the Treasury is permitted to waive all or a portion of the contributions required under the minimum funding standard for the year (a "waived funding deficiency"). In the case of a multiemployer plan, a waiver may be granted if 10 percent or more of the number of employers contributing to the plan could not make the required contribution without temporary substantial business hardship and if requiring the contribution would be adverse to the interests of plan participants in the aggregate. The minimum funding requirements may not be waived with respect to a multiemployer plan for more five out of any 15 consecutive years.

If a funding deficiency is waived, the waived amount is credited to the funding standard account. In the case of a multiemployer plan, the waived amount is then amortized over a period of 15 years, beginning with the year following the year in which the waiver is granted. Each year, the funding standard account is charged with the amortization amount for that year unless the plan becomes fully funded. In the case of a multiemployer plan, the

interest rate used for purposes of determining the amortization on the waived amount is the rate determined under section 6621(b) of the Internal Revenue Code (relating to the Federal short-term rate).

***Extension of amortization periods***

Amortization periods may be extended for up to 10 years by the Secretary of the Treasury if the Secretary finds that the extension would carry out the purposes of ERISA and would provide adequate protection for participants under the plan and if such Secretary determines that the failure to permit such an extension would (1) result in a substantial risk to the voluntary continuation of the plan or a substantial curtailment of pension benefit levels or employee compensation, and (2) be adverse to the interests of plan participants in the aggregate. The interest rate with respect to extensions of amortization periods is the same as that used with respect to waived funding deficiencies.

***Alternative funding standard account***

As an alternative to applying the rules described above, a plan which uses the entry age normal cost method may satisfy an alternative minimum funding standard. Under the alternative, the minimum required contribution for the year is generally based on the amount necessary to bring the plan's assets up to the present value of accrued benefits, determined using the actuarial assumptions that apply when a plan terminates. The alternative funding standard account has been rarely used.

***Controlled group liability for required contributions***

Unlike the rule for single-employer plans which imposes liability for minimum required contributions to all members of the employer's controlled group, controlled-group liability does not apply to contributions an employer is required to make to a multiemployer plan.

## *Explanation of Provision*

***Amortization periods***

The provision modifies the amortization periods applicable to multiemployer plans so that the amortization period for most charges is 15 years. Under the provision, past service liability under the plan is amortized over 15 years (rather than 30); past service liability due to plan amendments is amortized over 15 years (rather than 30); and experience gains and losses resulting from a change in actuarial assumptions are amortized over 15 years (rather than 30). As under present law, experience gains and losses and waived funding deficiencies are amortized over 15 years. The new amortization periods do not apply to amounts being amortized under present-law amortization periods, that is, no recalculation of amortization schedules already in effect is required under the provision. The provision eliminates the alternative funding standard account.

### *Actuarial assumptions*

The provision provides that in applying the funding rules, all costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods, each of which is reasonable (taking into account the experience of the plan and reasonable expectations). In addition, as under present law, the assumptions are required to offer the actuary's best estimate of anticipated experience under the plan.

### *Extension of amortization periods*

The provision provides that, upon application to the Secretary of the Treasury, the Secretary is required to grant an extension of the amortization period for up to five years with respect to any unfunded past service liability, investment loss, or experience loss. Included with the application must be a certification by the plan's actuary that (1) absent the extension, the plan would have an accumulated funding deficiency in the current plan year and any of the nine succeeding plan years, (2) the plan sponsor has adopted a plan to improve the plan's funding status, (3) taking into account the extension, the plan is projected to have sufficient assets to timely pay its expected benefit liabilities and other anticipated expenditures, and (4) required notice has been provided. The automatic extension provision does not apply with respect to any application submitted after December 31, 2014.

The Secretary of the Treasury may also grant an additional extension of such amortization periods for an additional five years. The standards for determining whether such an extension may be granted are the same as under present law. In addition, the provision requires the Secretary of the Treasury to act upon an application for an additional extension within 180 days after submission. If the Secretary rejects the application, the Secretary must provide notice to the plan detailing the specific reasons for the rejection.

As under present law, these extensions do not apply unless the applicant demonstrates to the satisfaction of the Treasury Secretary that notice of the application has been provided to each affected party (as defined in ERISA section 4001(a)(21)).

### *Interest rate applicable to funding waivers and extension of amortization periods*

The provision eliminates the special interest rate rule for funding waivers and extensions of amortization periods so that the plan rate applies.

### *Additional provisions*

#### *Controlled group liability for required contributions*

The provision imposes joint and several liability on all members of the employer's controlled group for minimum required contributions to single-employer or multiemployer plans.

#### *Shortfall funding method*

The provision provides that, for plan years beginning before January 1, 2015, certain multiemployer plans may adopt, use or cease using the shortfall funding method and such adoption, use, or ces-

sation of use is deemed approved by the Secretary of the Treasury. Plans are eligible if (1) the plan has not used the shortfall funding method during the five-year period ending on the day before the date the plan is to use the shortfall funding method; and (2) the plan is not operating under an amortization period extension and did not operate under such an extension during such five-year period. Benefit restrictions apply during a period that a multiemployer plan is using the shortfall funding method. In general, plan amendments increasing benefits cannot be adopted while the shortfall funding method is in use. The provision is not intended to affect a plan's ability to adopt the shortfall funding method with IRS approval or to affect a plan's right to change funding methods as otherwise permitted.

### *Effective Date*

The provision is effective for plan years beginning after 2007.

## B. Additional Funding Rules for Multiemployer Plans in Endangered or Critical Status (secs. 202, 212 and 221(c) of the Act, new sec. 305 of ERISA, and new sec. 432 of the Code)

### *Present Law*

#### *In general*

Multiemployer defined benefit plans are subject to minimum funding rules similar to those applicable to single-employer plans.[474] If a multiemployer plan has an accumulated funding deficiency for a year, an excise tax of five percent generally applies, increasing to 100 percent if contributions sufficient to eliminate the funding deficiency are not made within a certain period.

Additional required contributions and benefit reductions may apply if a multiemployer plan is in reorganization status or is insolvent.

#### *Reorganization status*

Certain modifications to the single-employer plan funding rules apply to multiemployer plans that experience financial difficulties, referred to as "reorganization status." A plan is in reorganization status for a year if the contribution needed to balance the charges and credits to its funding standard account exceeds its "vested benefits charge."[475] The plan's vested benefits charge is generally the amount needed to amortize, in equal annual installments, unfunded vested benefits under the plan over: (1) 10 years in the case of obligations attributable to participants in pay status; and (2) 25 years in the case of obligations attributable to other participants. A plan in reorganization status is eligible for a special funding credit. In addition, a cap on year-to-year contribution increases and

[474] See the explanation of the preceding provision for a discussion of the minimum funding rules for multiemployer defined benefit plans. Under Treasury regulations, certain noncollectively bargained employees covered by a multiemployer plan may be treated as collectively bargained employees for purposes of applying the minimum coverage rules of the Code. Treas. Reg. sec. 1.410(b)–6(d)(2)(ii)(D).

[475] ERISA sec. 4241; Code sec. 418.

other relief is available to employers that continue to contribute to the plan.

Subject to certain requirements, a multiemployer plan in reorganization status may also be amended to reduce or eliminate accrued benefits in excess of the amount of benefits guaranteed by the PBGC.[476] Benefits may be reduced or eliminated notwithstanding the anti-cutback rules, which generally require that accrued benefits may not be decreased by plan amendment. In order for accrued benefits to be reduced, at least six months before the beginning of the plan year in which the amendment is adopted, notice must be given that the plan is in reorganization status and that, if contributions to the plan are not increased, accrued benefits will be reduced or an excise tax will be imposed on employers obligated to contribute to the plan. The notice must be provided to plan participants and beneficiaries, any employer who has an obligation to contribute to the plan, and any employee organization representing employees in the plan.

### *Insolvency*

In the case of multiemployer plans, the PBGC insures plan insolvency, rather than plan termination. A plan is insolvent when its available resources are not sufficient to pay the plan benefits for the plan year in question, or when the sponsor of a plan in reorganization reasonably determines, taking into account the plan's recent and anticipated financial experience, that the plan's available resources will not be sufficient to pay benefits that come due in the next plan year.[477] Notwithstanding the anti-cutback rules, an insolvent plan is required to reduce benefits to the level that can be covered by the plan's assets. However, benefits cannot be reduced below the level guaranteed by the PBGC.[478] If a multiemployer plan is insolvent, the PBGC guarantee is provided in the form of loans to the plan trustees. If the plan recovers from insolvency status, loans from the PBGC can be repaid. Plans in reorganization status are required to compare assets and liabilities to determine if the plan will become insolvent in the future.

## *Explanation of Provision*

### *In general*

The provision provides additional funding rules for multiemployer defined benefit plans in effect on July 16, 2006, that are in endangered or critical status. The provision requires the adoption of and compliance with (1) a funding improvement plan in the case of a multiemployer plan in endangered status, and (2) a rehabilitation plan in the case of a multiemployer plan in critical status.

Under the provision, in the case of a plan in critical status, additional required contributions and benefit reductions apply and employers are relieved of liability for minimum required contributions under the otherwise applicable funding rules, provided that a rehabilitation plan is adopted and followed.

---

[476] ERISA sec. 4244A; Code sec. 418D.

[477] ERISA sec. 4245; Code sec. 418E.

[478] The limit of benefits that the PBGC guarantees under a multiemployer plan is the sum of 100 percent of the first $11 of monthly benefits and 75 percent of the next $33 of monthly benefits for each year of service. ERISA sec. 4022A(c).

***Annual certification of status; notice; annual reports***

Not later than the 90th day of each plan year, the plan actuary must certify to the Secretary of the Treasury and to the plan sponsor whether or not the plan is in endangered or critical status for the plan year. In the case of a plan that is in a funding improvement or rehabilitation period, the actuary must certify whether or not the plan is making scheduled progress in meeting the requirements of its funding improvement or rehabilitation plan.

In making the determinations and projections applicable under the endangered and critical status rules, the plan actuary must make projections for the current and succeeding plan years of the current value of the assets of the plan and the present value of all liabilities to participants and beneficiaries under the plan for the current plan year as of the beginning of such year. The actuary's projections must be based on reasonable actuarial estimates, assumptions, and methods that offer the actuary's best estimate of anticipated experience under the plan. An exception to this rule applies in the case of projected industry activity. Any projection of activity in the industry or industries covered by the plan, including future covered employment and contribution levels, must be based on information provided by the plan sponsor, which shall act reasonably and in good faith. The projected present value of liabilities as of the beginning of the year must be based on the most recent actuarial statement required with respect to the most recently filed annual report or the actuarial valuation for the preceding plan year.

Any actuarial projection of plan assets must assume (1) reasonably anticipated employer contributions for the current and succeeding plan years, assuming that the terms of one or more collective bargaining agreements pursuant to which the plan is maintained for the current plan year continue in effect for the succeeding plan years, or (2) that employer contributions for the most recent plan year will continue indefinitely, but only if the plan actuary determines that there have been no significant demographic changes that would make continued assumption of such terms unreasonable.

Failure of the plan's actuary to certify the status of the plan is treated as a failure to file the annual report (thus, an ERISA penalty of up to $1,100 per day applies).

If a plan is certified to be in endangered or critical status, notification of the endangered or critical status must be provided within 30 days after the date of certification to the participants and beneficiaries, the bargaining parties, the PBGC and the Secretary of Labor.[479] If it is certified that a plan is or will be in critical status, the plan sponsor must included in the notice an explanation of the possibility that (1) adjustable benefits may be reduced and (2) such reductions may apply to participants and beneficiaries whose benefit commencement date is on or after the date such notice is provided for the first plan year in which the plan is in critical status.

[479] If a plan actuary certifies that it is reasonably expected that a plan will be in critical status with respect to the first plan year after 2007, notice may be provided at any time after date of enactment, as long as it is provided on or before the date otherwise required.

The Secretary of Labor is required to prescribe a model notice to satisfy these requirements.

The plan sponsor must annually update the funding improvement or rehabilitation plan. Updates are required to be filed with the plan's annual report.

***Endangered status***

*Definition of endangered status*

A multiemployer plan is in endangered status if the plan is not in critical status and, as of the beginning of the plan year, (1) the plan's funded percentage for the plan year is less than 80 percent, or (2) the plan has an accumulated funding deficiency for the plan year or is projected to have an accumulated funding deficiency in any of the six succeeding plan years (taking into account amortization extensions). A plan's funded percentage is the percentage of plan assets over accrued liability of the plan. A plan that meets the requirements of both (1) and (2) is treated as in seriously endangered status.

*Information to be provided to bargaining parties*

Within 30 days of the adoption of a funding improvement plan, the plan sponsor must provide to the bargaining parties schedules showing revised benefit structures, revised contribution structures, or both, which, if adopted, may reasonably be expected to enable the multiemployer plan to meet the applicable benchmarks in accordance with the funding improvement plan, including (1) one proposal for reductions in the amount of future benefit accruals necessary to achieve the applicable benchmarks, assuming no amendments increasing contributions under the plan (other than amendments increasing contributions necessary to achieve the applicable benchmarks after amendments have reduced future benefit accruals to the maximum extent permitted by law) (the "default schedule"), and (2) one proposal for increases in contributions under the plan necessary to achieve the applicable benchmarks, assuming no amendments reducing future benefit accruals under the plan. The applicable benchmarks are the requirements of the funding improvement plan (discussed below). The plan sponsor may provide the bargaining parties with additional information if deemed appropriate.

The plan sponsor must annually update any schedule of contribution rates to reflect the experience of the plan.

*Funding improvement plan and funding improvement period*

In the case of a multiemployer plan in endangered status, a funding improvement plan must be adopted within 240 days following the deadline for certifying a plan's status.[480] A funding improvement plan is a plan which consists of the actions, including options or a range of options, to be proposed to the bargaining parties, formulated to provide, based on reasonably anticipated experi-

[480] This requirement applies for the initial determination year (i.e., the first plan year that the plan is in endangered status).

ence and reasonable actuarial assumptions, for the attainment by the plan of certain requirements.

The funding improvement plan must provide that during the funding improvement period, the plan will have a certain required increase in the funded percentage and no accumulated funding deficiency for any plan year during the funding improvement period, taking into account amortization extensions (the "applicable benchmarks"). In the case of a plan that is not in seriously endangered status, under the applicable benchmarks, the plan's funded percentage must increase such that the funded percentage as of the close of the funding improvement period equals or exceeds a percentage equal to the sum of (1) the funded percentage at the beginning of the period, plus (2) 33 percent of the difference between 100 percent and the percentage in (1). Thus, the difference between 100 percent and the plan's funded percentage at the beginning of the period must be reduced by at least one-third during the funding improvement period.

The funding improvement period is the 10-year period beginning on the first day of the first plan year beginning after the earlier of (1) the second anniversary of the date of adoption of the funding improvement plan, or (2) the expiration of collective bargaining agreements that were in effect on the due date for the actuarial certification of endangered status for the initial determination year and covering, as of such date, at least 75 percent of the plan's active participants. The period ends if the plan is no longer in endangered status or if the plan enters critical status.

In the case of a plan in seriously endangered status that is funded 70 percent or less, under the applicable benchmarks, the difference between 100 percent and the plan's funded percentage at the beginning of the period must be reduced by at least one-fifth during the funding improvement period. In the case of such plans, a 15-year funding improvement period is used.

In the case of a seriously endangered plan that is more than 70 percent funded as of the beginning of the initial determination year, the same benchmarks apply for plan years beginning on or before the date on which the last collective bargaining agreements in effect on the date for actuarial certification for the initial determination year and covering at least 75 percent of active employees in the multiemployer plan have expired if the plan actuary certifies within 30 days after certification of endangered status that the plan is not projected to attain the funding percentage increase otherwise required by the provision. Thus, for such plans, the difference between 100 percent and the plan's funded percentage at the beginning of the period must be reduced by at least one-fifth during the 15-year funding improvement period. For subsequent years for such plans, if the plan actuary certifies that the plan is not able to attain the increase generally required under the provision, the same benchmarks continue to apply.

As previously discussed, the plan sponsor must annually update the funding improvement plan and must file the update with the plan's annual report.

If, for the first plan year following the close of the funding improvement period, the plan's actuary certifies that the plan is in endangered status, such year is treated as an initial determination

year. Thus, a new funding improvement plan must be adopted within 240 days of the required certification date. In such case, the plan may not be amended in a manner inconsistent with the funding improvement plan in effect for the preceding plan year until a new funding improvement plan is adopted.

*Requirements pending approval of plan and during funding improvement period*

Certain restrictions apply during the period beginning on the date of certification for the initial determination year and ending on the day before the first day of the funding improvement period (the "funding plan adoption period").

During the funding plan adoption period, the plan sponsor may not accept a collective bargaining agreement or participation agreement that provides for (1) a reduction in the level of contributions for any participants; (2) a suspension of contributions with respect to any period of service; or (3) any new or indirect exclusion of younger or newly hired employees from plan participation.

In addition, during the funding plan adoption period, except in the case of amendments required as a condition of qualification under the Internal Revenue Code or to apply with other applicable law, no amendment may be adopted which increases liabilities of the plan by reason of any increase in benefits, any change in accrual of benefits, or any change in the rate at which benefits become nonforfeitable under the plan.

In the case of a plan in seriously endangered status, during the funding plan adoption period, the plan sponsor must take all reasonable actions (consistent with the terms of the plan and present law) which are expected, based on reasonable assumptions, to achieve an increase in the plan's funded percentage and a postponement of an accumulated funding deficiency for at least one additional plan year. These actions include applications for extensions of amortization periods, use of the shortfall funding method in making funding standard account computations, amendments to the plan's benefit structure, reductions in future benefit accruals, and other reasonable actions.

Upon adoption of a funding improvement plan, the plan may not be amended to be inconsistent with the funding improvement plan. During the funding improvement period, a plan sponsor may not accept a collective bargaining agreement or participation agreement with respect to the multiemployer plan that provides for (1) a reduction in the level of contributions for any participants; (2) a suspension of contributions with respect to any period of service, or (3) any new direct or indirect exclusion of younger or newly hired employees from plan participation.

After the adoption of a funding improvement plan, a plan may not be amended to increase benefits, including future benefit accruals, unless the plan actuary certifies that the benefit increase is consistent with the funding improvement plan and is paid for out of contributions not required by the funding improvement plan to meet the applicable benchmark in accordance with the schedule contemplated in the funding improvement plan.

*Effect of and penalty for failure to adopt a funding improvement plan*

If a collective bargaining agreement providing for contributions under a multiemployer plan that was in effect at the time the plan entered endangered status expires, and after receiving one or more schedules from the plan sponsor, the bargaining parties fail to agree on changes to contribution or benefit schedules necessary to meet the applicable benchmarks, the plan sponsor must implement the default schedule. The schedule must be implemented on the earlier of the date (1) on which the Secretary of Labor certifies that the parties are at an impasse, or (2) which is 180 days after the date on which the collective bargaining agreement expires.

In the case of the failure of a plan sponsor to adopt a funding improvement plan by the end of the 240-day period after the required certification date, an ERISA penalty of up to $1,100 a day applies.

*Excise tax on employers failing to meet required contributions*

If the funding improvement plan requires an employer to make contributions to the plan, an excise tax applies upon the failure of the employer to make such required contributions within the time required under the plan. The amount of tax is equal to the amount of the required contribution the employer failed to make in a timely manner.

*Application of excise tax to plans in endangered status/penalty for failure to achieve benchmarks*

In the case of a plan in endangered status, which is not in seriously endangered status, a civil penalty of $1,100 a day applies for the failure of the plan to meet the applicable benchmarks by the end of the funding improvement period.

In the case of a plan in seriously endangered status, an excise tax applies for the failure to meet the benchmarks by the end of the funding improvement period. In such case, an excise tax applies based on the greater of (1) the amount of the contributions necessary to meet such benchmarks or (2) the plan's accumulated funding deficiency. The excise tax applies for each succeeding plan year until the benchmarks are met.

*Waiver of excise tax*

In the case of a failure which is due to reasonable cause and not to willful neglect, the Secretary of the Treasury may waive all or part of the excise tax on employers failing to make required contributions and the excise tax for failure to achieve the applicable benchmarks. The party against whom the tax is imposed has the burden of establishing that the failure was due to reasonable cause and not willful neglect. Reasonable cause includes unanticipated and material market fluctuations, the loss of a significant contributing employer, or other factors to the extent that the payment of tax would be excessive or otherwise inequitable relative to the failure involved. The determination of reasonable cause is based on the facts and circumstances of each case and requires the parties to act with ordinary business care and prudence. The standard requires the funding improvement plan to be based on reasonably

foreseeable events. It is expected that reasonable cause would include instances in which the plan experiences a net equity loss of at least ten percent during the funding improvement period, a change in plan demographics such as the bankruptcy of a significant contributing employer, a legal change (including the outcome of litigation) that unexpectedly increases the plan's benefit obligations, or a strike or lockout for a significant period.

***Critical status***

*Definition of critical status*

A multiemployer plan is in critical status for a plan year if as of the beginning of the plan year:

1. The funded percentage of the plan is less than 65 percent and the sum of (A) the market value of plan assets, plus (B) the present value of reasonably anticipated employer and employee contributions for the current plan year and each of the six succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all benefits projected to be payable under the plan during the current plan year and each of the six succeeding plan years (plus administrative expenses),

2. (A) The plan has an accumulated funding deficiency for the current plan year, not taking into account any amortization extension, or (B) the plan is projected to have an accumulated funding deficiency for any of the three succeeding plan years (four succeeding plan years if the funded percentage of the plan is 65 percent or less), not taking into account any amortization extension,

3. (A) The plan's normal cost for the current plan year, plus interest for the current plan year on the amount of unfunded benefit liabilities under the plan as of the last day of the preceding year, exceeds the present value of the reasonably anticipated employer contributions for the current plan year, (B) the present value of nonforfeitable benefits of inactive participants is greater than the present value of nonforfeitable benefits of active participants, and (C) the plan has an accumulated funding deficiency for the current plan year, or is projected to have an accumulated funding deficiency for any of the four succeeding plan years (not taking into account amortization period extensions), or

4. The sum of (A) the market value of plan assets, plus (B) the present value of the reasonably anticipated employer contributions for the current plan year and each of the four succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all benefits projected to be payable under the plan during the current plan year and each of the four succeeding plan years (plus administrative expenses).

*Additional contributions during critical status*

In the case of a plan in critical status, the provision imposes an additional required contribution ("surcharge") on employers otherwise obligated to make a contribution in the initial critical year,

i.e., the first plan year for which the plan is in critical status. The amount of the surcharge is five percent of the contribution otherwise required to be made under the applicable collective bargaining agreement. The surcharge is 10 percent of contributions otherwise required in the case of succeeding plan years in which the plan is in critical status. The surcharge applies 30 days after the employer is notified by the plan sponsor that the plan is in critical status and the surcharge is in effect. The surcharges are due and payable on the same schedule as the contributions on which the surcharges are based. Failure to make the surcharge payment is treated as a delinquent contribution. The surcharge is not required with respect to employees covered by a collective bargaining agreement (or other agreement pursuant to which the employer contributes), beginning on the effective date of a collective bargaining agreement (or other agreement) that includes terms consistent with a schedule presented by the plan sponsor. The amount of the surcharge may not be the basis for any benefit accrual under the plan.

Surcharges are disregarded in determining an employer's withdrawal liability except for purposes of determining the unfunded vested benefits attributable to an employer under ERISA section 4211(c)(4) or a comparable method approved under ERISA section 4211(c)(5).[481]

*Reductions to previously earned benefits*

Notwithstanding the anti-cutback rules, the plan sponsor may make any reductions to adjustable benefits which the plan sponsor deems appropriate, based upon the outcome of collective bargaining over the schedules required to be provided by the plan sponsor as discussed below. Adjustable benefits means (1) benefits, rights, and features under the plan, including post-retirement death benefits, 60-month guarantees, disability benefits not yet in pay status, and similar benefits; (2) any early retirement benefit or retirement-type subsidy and any benefit payment option (other than the qualified joint-and-survivor annuity); and (3) benefit increase that would not be eligible for PBGC guarantee on the first day of the initial critical year because the increases were adopted (or, if later, took effect) less than 60 months before such first day. Except as provided in (3), nothing should be construed to permit a plan to reduce the level of a participant's accrued benefit payable at normal retirement age.

The plan sponsor may not reduce adjustable benefits of any participant or beneficiary whose benefit commencement date is before the date on which the plan provides notice to the participant or beneficiary that the plan is in critical status and that benefits may be reduced. An exception applies in the case of benefit increases that would not be eligible for PBGC guarantee because the increases were adopted less than 60 months before the first day of the initial critical year.

The plan sponsor must include in the schedules provided to the bargaining parties an allowance for funding the benefits of participants with respect to whom contributions are not currently re-

[481] The PBGC is directed to prescribe simplified methods for determining withdrawal liability in this case.

quired to be made, and shall reduce their benefits to the extent permitted under the Code and ERISA and considered appropriate by the plan sponsor based on the plan's then current overall funding status.

Notice of any reduction of adjustable benefits must be provided at least 30 days before the general effective date of the reduction for all participants and beneficiaries. Benefits may not be reduced until the notice requirement is satisfied. Notice must be provided to (1) plan participants and beneficiaries; (2) each employer who has an obligation to contribute under the plans; and (3) each employee organization which, for purposes of collective bargaining, represents plan participants employed by such employer. The notice must contain (1) sufficient information to enable participants and beneficiaries to understand the effect of any reduction of their benefits, including an estimate (on an annual or monthly basis) of any affected adjustable benefit that a participant or beneficiary would otherwise have been eligible for as of the general effective date for benefit reductions; and (2) information as to the rights and remedies of plan participants and beneficiaries as well as how to contact the Department of Labor for further information and assistance where appropriate. The notice must be provided in a form and manner prescribed in regulations of the Secretary of Labor. In such regulations, the Secretary of Labor must establish a model notice.

Benefit reduction are disregarded in determining a plan's unfunded vested benefits for purposes of determining an employer's withdrawal liability.[482]

*Information to be provided to bargaining parties*

Within 30 days after adoption of the rehabilitation plan, the plan sponsor must provide to the bargaining parties schedules showing revised benefit structures, revised contribution structures, or both which, if adopted, may reasonably be expected to enable the multiemployer plan to emerge from critical status in accordance with the rehabilitation plan.[483] The schedules must reflect reductions in future benefit accruals and adjustable benefits and increases in contributions that the plan sponsor determined are reasonably necessary to emerge from critical status. One schedule must be designated as the default schedule and must assume no increases in contributions other than increases necessary to emerge from critical status after future benefit accruals and other benefits (other than benefits the reduction or elimination of which are not permitted under the anti-cutback rules) have been reduced. The plan sponsor may also provide additional information as appropriate.

The plan sponsor must periodically update any schedule of contributions rates to reflect the experience of the plan.

---

[482] The PBGC is directed to prescribe simplified methods for determining withdrawal liability in this case.

[483] A schedule of contribution rates provided by the plan sponsor and relied upon by bargaining parties in negotiating a collective bargaining agreement must remain in effect for the duration of the collective bargaining agreement.

*Rehabilitation plan*

If a plan is in critical status for a plan year, the plan sponsor must adopt a rehabilitation plan within 240 days following the required date for the actuarial certification of critical status.[484]

A rehabilitation plan is a plan which consists of actions, including options or a range of options to be proposed to the bargaining parties, formulated, based on reasonable anticipated experience and reasonable actuarial assumptions, to enable the plan to cease to be in critical status by the end of the rehabilitation period and may include reductions in plan expenditures (including plan mergers and consolidations), reductions in future benefits accruals or increases in contributions, if agreed to by the bargaining parties, or any combination of such actions.

A rehabilitation plan must provide annual standards for meeting the requirements of the rehabilitation. The plan must also include the schedules required to be provided to the bargaining parties.

If the plan sponsor determines that, based on reasonable actuarial assumptions and upon exhaustion of all reasonable measures, the plan cannot reasonably be expected to emerge from critical status by the end of the rehabilitation period, the plan must include reasonable measures to emerge from critical status at a later time or to forestall possible insolvency. In such case, the plan must set forth alternatives considered, explain why the plan is not reasonably expected to emerge from critical status by the end of the rehabilitation period, and specify when, if ever, the plan is expected to emerge from critical status in accordance with the rehabilitation plan.

As previously discussed, the plan sponsor must annually update the rehabilitation plan and must file the update with the plan's annual report.

*Rehabilitation period*

The rehabilitation period is the 10-year period beginning on the first day of the first plan year following the earlier of (1) the second anniversary of the date of adoption of the rehabilitation plan or (2) the expiration of collective bargaining agreements that were in effect on the due date for the actuarial certification of critical status for the initial critical year and covering at least 75 percent of the active participants in the plan.

The rehabilitation period ends if the plan emerges from critical status. A plan in critical status remains in critical status until a plan year for which the plan actuary certifies that the plan is not projected to have an accumulated funding deficiency for the plan year or any of the nine succeeding plan years, without regard to the use of the shortfall method and taking into account amortization period extensions.

*Rules for reductions in future benefit accrual rates*

Any schedule including reductions in future benefit accruals forming part of a rehabilitation plan must not reduce the rate of benefit accruals below (1) a monthly benefit (payable as a single life annuity commencing at the participant's normal retirement

[484] The requirement applies with respect to the initial critical year.

age) equal to one percent of the contributions required to be made with respect to a participant or the equivalent standard accrual rate for a participant or group of participants under the collective bargaining agreements in effect as of the first day of the initial critical year, or (2) if lower, the accrual rate under the plan on such first day.

The equivalent standard accrual rate is determined by the plan sponsor based on the standard or average contribution base units which the plan sponsor determines to be representative for active participants and such other factors that the plan sponsor determines to be relevant. The provision does not limit the ability of the plan sponsor to prepare and provide the bargaining parties with alternative schedules to the default schedule that establish lower or higher accrual and contribution rates than the rates described above.

Benefit reductions are disregarded in determining an employer's withdrawal liability.

*Requirements pending approval and during rehabilitation period*

*Rehabilitation plan adoption period.*—Certain restrictions apply during the period beginning on the date of certification and ending on the day before the first day of the rehabilitation period (defined as the "rehabilitation plan adoption period").

During the rehabilitation plan adoption period, the plan sponsor may not accept a collective bargaining agreement or participation agreement that provides for (1) a reduction in the level of contributions for any participants; (2) a suspension of contributions with respect to any period of service; or (3) any new direct or indirect exclusion of younger or newly hired employees from plan participation. Except in the case of amendments required as a condition of qualification under the Internal Revenue Code or to comply with other applicable law, during the rehabilitation plan adoption period, no amendments that increase the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits become nonforfeitable may be adopted.

*During rehabilitation period.*—A plan may not be amended after the date of adoption of a rehabilitation plan to be inconsistent with the rehabilitation plan.

A plan may not be amended after the date of adoption of a rehabilitation plan to increase benefits (including future benefit accruals) unless the plan actuary certifies that such increase is paid for out of additional contributions not contemplated by the rehabilitation plan and, after taking into account the benefit increases, the plan is still reasonably expected to emerge from critical status by the end of the rehabilitation period on the schedule contemplated by the rehabilitation plan.

Beginning on the date that notice of certification of the plan's critical status is sent, lump sum and other similar benefits may not be paid. The restriction does not apply if the present value of the participant's accrued benefit does not exceed $5,000. The restriction also does not apply to any makeup payment in the case of a retro-

active annuity starting date or any similar payment of benefits owed with respect to a prior period.

The plan sponsor must annually update the plan and must file updates with the plan's annual report. Schedules must be annually updated to reflect experience of the plan.

*Effect and penalty for failure to adopt a rehabilitation plan*

If a collective bargaining agreement providing for contributions under a multiemployer plan that was in effect at the time the plan entered endangered status expires, and after receiving one of more schedules from the plan sponsor, the bargaining parties fail to adopt a contribution or benefit schedule with terms consistent with the rehabilitation plan and the scheduled from the plan sponsor, the plan sponsor must implement the default schedule. The schedule must be implemented on the earlier of the date (1) on which the Secretary of Labor certifies that the parties are at an impasse, or (2) which is 180 days after the date on which the collective bargaining agreement expires.

Upon the failure of a plan sponsor to adopt a rehabilitation plan within 240 days after the date required for certification, an ERISA penalty of $1,100 a day applies. In addition, upon the failure to timely adopt a rehabilitation plan, an excise tax is imposed on the plan sponsor equal to the greater of (1) the present law excise tax or (2) $1,100 per day. The tax must be paid by the plan sponsor.

*Excise tax on employers failing to meet required contributions*

If the rehabilitation plan requires an employer to make contributions to the plan, an excise tax applies upon the failure of the employer to make such required contributions within the time required under the plan. The amount of tax is equal to the amount of the required contribution the employer failed to make in a timely manner.

*Application of excise tax to plans in critical status/penalty for failure to meet benchmarks or make scheduled progress*

In the case of a plan in critical status, if a rehabilitation plan is adopted and complied with, employers are not liable for contributions otherwise required under the general funding rules. In addition, the present-law excise tax does not apply.

If a plan fails to leave critical status at the end of the rehabilitation period or fails to make scheduled progress in meeting its requirements under the rehabilitation plan for three consecutive years, the present law excise tax applies based on the greater of (1) the amount of the contributions necessary to leave critical status or make scheduled progress or (2) the plan's accumulated funding deficiency. The excise tax applies for each succeeding plan year until the requirements are met.

*Waiver of excise tax*

In the case of a failure which is due to reasonable cause and not to willful neglect, the Secretary of the Treasury may waive all or part of the excise tax on employers failing to make required contributions and the excise tax for failure to meet the rehabilitation

plan requirements or make scheduled progress. The standards applicable to waivers of the excise tax for plans in endangered status apply to waivers of plans in critical status.

***Additional rules***

*In general*

The actuary's determination with respect to a plan's normal cost, actuarial accrued liability, and improvements in a plan's funded percentage must be based on the unit credit funding method (whether or not that method is used for the plan's actuarial valuation).

In the case of a plan sponsor described under section 404(c) of the Code, the term "plan sponsor" means the bargaining parties.

*Expedited resolution of plan sponsor decisions*

If, within 60 days of the due date for the adoption of a funding improvement plan or a rehabilitation plan, the plan sponsor has not agreed on a funding improvement plan or a rehabilitation plan, any member of the board or group that constitutes the plan sponsor may require that the plan sponsor enter into an expedited dispute resolution procedure for the development and adoption of a funding improvement plan or rehabilitation plan.

*Nonbargained participation*

In the case of an employer who contributes to a multiemployer plan with respect to both employees who are covered by one or more collective bargaining agreements and to employees who are not so covered, if the plan is in endangered or critical status, benefits of and contributions for the nonbargained employees, including surcharges on those contributions, must be determined as if the nonbargained employees were covered under the first to expire of the employer's collective bargaining agreements in effect when the plan entered endangered or critical status.[485] In the case of an employer who contributes to a multiemployer plan only with respect to employees who are not covered by a collective bargaining agreement, the additional funding rules apply as if the employer were the bargaining party, and its participation agreement with the plan was a collective bargaining agreement with a term ending on the first day of the plan year beginning after the employer is provided the schedule requires to be provided by the plan sponsor.

*Special rule for certain restored benefits*

In the case of benefits which were reduced pursuant to a plan amendment adopted on or after January 1, 2002, and before June 30, 2005, if, pursuant to the plan document, the trust agreement, or a formal written communication from the plan sponsor to participants provided before June 30, 2005, such benefits were restored, the rules under the provision do not apply to such benefit restorations to the extent that any restriction on the providing or

[485] Treasury regulations allowing certain noncollectively bargained employees covered by a multiemployer plan to be treated as collectively bargained employees for purposes of the minimum coverge rules of the Code do not apply in making determinations under the provision.

accrual of such benefits would otherwise apply by reason of the provision.

*Cause of action to compel adoption of funding improvement or rehabilitation plan*

The provision creates a cause of action under ERISA in the case that the plan sponsor of a plan certified to be in endangered or critical (1) has not adopted a funding improvement or rehabilitation plan within 240 days of certification of endangered or critical or (2) fails to update or comply with the terms of the funding improvement or rehabilitation plan. In such case, a civil action may be brought by an employer that has an obligation to contribute with respect to the plan, or an employee organization that represents active participants, for an order compelling the plan sponsor to adopt a funding improvement or rehabilitation plan or to update or comply with the terms of the funding improvement or rehabilitation plan.

### *Effective Date*

The provision is effective for plan years beginning after 2007. The additional funding rules for plans in endangered or critical status do not apply to plan years beginning after December 31, 2014.

If a plan is operating under a funding improvement or rehabilitation plan for its last year beginning before January 1, 2015, the plan shall continue to operate under such funding improvement or rehabilitation plan during any period after December 31, 2014, that such funding improvement or rehabilitation plan is in effect.

## C. Measures to Forestall Insolvency of Multiemployer Plans (secs. 203 and 213 of the Act, sec. 4245 of ERISA, and sec. 418E of the Code)

### *Present Law*

In the case of multiemployer plans, the PBGC insures plan insolvency, rather than plan termination. A plan is insolvent when its available resources are not sufficient to pay the plan benefits for the plan year in question, or when the sponsor of a plan in reorganization reasonably determines, taking into account the plan's recent and anticipated financial experience, that the plan's available resources will not be sufficient to pay benefits that come due in the next plan year.

In order to anticipate future insolvencies, at the end of the first plan year in which a plan is in reorganization and at least every three plans year thereafter, the plan sponsor must compare the value of plan assets for the plan year with the total amount of benefit payments made under the plan for the plan year.[486] Unless the plan sponsor determines that the value of plan assets exceeds three times the total amount of benefit payments, the plan sponsor must determine whether the plan will be insolvent for any of the next three plan years.

[486] Code sec. 418E(d)(1); ERISA sec. 4245(d)(1).

### *Explanation of Provision*

The provision modifies the requirements for anticipating future insolvencies of plans in reorganization status. Under the provision, unless the plan sponsor determines that the value of plan assets exceeds three times the total amount of benefit payments, the plan sponsor must determine whether the plan will be insolvent for any of the next five plan years, rather than three plan years as under present law. If the plan sponsor makes a determination that the plan will be insolvent for any of the next five plan years, the plan sponsor must make the comparison of plan assets and benefit payments under the plan at least annually until the plan sponsor makes a determination that the plan will not be insolvent in any of the next five plan years.

### *Effective Date*

The provision is effective with respect to determinations made in plan years beginning after 2007.

## D. Withdrawal Liability Reforms (sec. 204 of the Act, and secs. 4203, 4205, 4210, 4219, 4221 and 4225 of ERISA)

### 1. Update of rules relating to limitation on withdrawal liability in certain cases

### *Present Law*

Under ERISA, an employer which withdraws from a multiemployer plan in a complete or partial withdrawal is liable to the plan in the amount determined to be the employer's withdrawal liability.[487] In general, a "complete withdrawal" means the employer has permanently ceased operations under the plan or has permanently ceased to have an obligation to contribute.[488] A "partial withdrawal" generally occurs if, on the last day of a plan year, there is a 70-percent contribution decline for such plan year or there is a partial cessation of the employer's contribution obligation.[489]

When an employer withdraws from a multiemployer plan, the plan sponsor is required to determine the amount of the employer's withdrawal liability, notify the employer of the amount of the withdrawal liability, and collect the amount of the withdrawal liability from the employer.[490] The employer's withdrawal liability generally is based on the extent of the plan's unfunded vested benefits for the plan years preceding the withdrawal.[491]

ERISA section 4225 provides rules limiting or subordinating withdrawal liability in certain cases. The amount of unfunded vested benefits allocable to an employer is limited in the case of certain sales of all or substantially all of the employer's assets[492] and in

[487] ERISA sec. 4201.
[488] ERISA sec. 4203.
[489] ERISA sec. 4205.
[490] ERISA sec. 4202.
[491] ERISA secs. 4209 and 4211.
[492] ERISA sec. 4225(a).

the case of an insolvent employer undergoing liquidation or dissolution.[493]

In the case of a bona fide sale of all or substantially all of the employer's assets in an arm's length transaction to an unrelated party, the unfunded vested benefits allocable to an employer is limited to the greater of (1) a portion of the liquidation or dissolution value of the employer (determined after the sale or exchange of such assets), or (2) the unfunded vested benefits attributable to the employees of the employer. The portion to be used in (1) is determined in accordance with a table described in ERISA section 4225(a)(2). Other limitations on withdrawal liability also apply.

### *Explanation of Provision*

The provision prescribes a new table under ERISA section 4225(a)(2) to be used in determining the portion of the liquidation or dissolution value of the employer for the calculation of the limitation of unfunded vested benefits allocable to an employer in the case of a bona fide sale of all or substantially all of the employer's assets in an arm's length transaction to an unrelated party. The provision also modifies the calculation of the limit so that the unfunded vested benefits allocable to an employer do not exceed the greater of (1) a portion of the liquidation or dissolution value of the employer (determined after the sale or exchange of such assets), or (2) in the case of a plan using the attributable method of allocating withdrawal liability, the unfunded vested benefits attributable to the employees of the employer. Present law ERISA section 4225(b) is not amended by the provision.

### *Effective Date*

The provisions are effective for sales occurring on or after January 1, 2007.

## 2. Withdrawal liability continues if work contracted out

### *Present Law*

Under ERISA, an employer which withdraws from a multiemployer plan in a complete or partial withdrawal is liable to the plan in the amount determined to be the employer's withdrawal liability.[494] In general, a "complete withdrawal" means the employer has permanently ceased operations under the plan or has permanently ceased to have an obligation to contribute.[495]

A "partial withdrawal" generally occurs if, on the last day of a plan year, there is a 70-percent contribution decline for such plan year or there is a partial cessation of the employer's contribution obligation.[496] A partial cessation of the employer's obligation occurs if (1) the employer permanently ceases to have an obligation to contribute under one or more, but fewer than all collective bargaining agreements under which obligated to contribute, but the employer continues to perform work in the jurisdiction of the collective bar-

[493] ERISA sec. 4225(b).
[494] ERISA sec. 4201.
[495] ERISA sec. 4203.
[496] ERISA sec. 4205.

gaining agreement or transfers such work to another location or (2) an employer permanently ceases to have an obligation to contribute under the plan with respect to work performed at one or more, but fewer than all of its facilities, but continues to perform work at the facility of the type for which the obligation to contribute ceased.[497]

### *Explanation of Provision*

Under the provision, a partial withdrawal also occurs if the employer permanently ceases to have an obligation to contribute under one or more, but fewer than all collective bargaining agreements under which obligated to contribute, but the employer transfers such work to an entity or entities owned or controlled by the employer.

### *Effective Date*

The provision is effective with respect to work transferred on or after the date of enactment (August 17, 2006).

## 3. Application of forgiveness rule to plans primarily covering employees in building and construction

### *Present Law*

Under ERISA, an employer which withdraws from a multiemployer plan in a complete or partial withdrawal is liable to the plan in the amount determined to be the employer's withdrawal liability.[498] A multiemployer plan, other than a plan which primarily covers employees in the building and construction industry, may adopt a rule that an employer who withdraws from the plan is not subject to withdrawal liability if certain requirements are satisfied.[499] In general, the employer is not liable if the employer (1) first had an obligation to contribute to the plan after the date of enactment of the Multiemployer Pension Plan Amendments Act of 1980; (2) contributed to the plan for no more than the lesser of six plan years or the number of years required for vesting under the plan; (3) was required to make contributions to the plan for each year in an amount equal to less than two percent of all employer contributions for the year; and (4) never avoided withdrawal liability because of the special rule.

A multiemployer plan, other than a plan that primarily covers employees in the building and construction industry, may be amended to provide that the amount of unfunded benefits allocable to an employer that withdraws from the plan is determined under an alternative method.[500]

### *Explanation of Provision*

The provision extends the rule allowing plans to exempt certain employers from withdrawal liability to plans primarily covering employees in the building and construction industry. In addition, the provision also provides that a plan (including a plan which pri-

[497] ERISA sec. 4205(b)(2).
[498] ERISA sec. 4201.
[499] ERISA sec. 4210.
[500] ERISA sec. 4211(c)(1).

marily covers employees in the building and construction industry) may be amended to provide that the withdrawal liability method otherwise applicable shall be applied by substituting the plan year which is specified in the amendment and for which the plan has no unfunded vested benefits for the plan year ending before September 26, 1980.

### *Effective Date*

The provision is effective with respect to plan withdrawals occurring on or after January 1, 2007.

## 4. Procedures applicable to disputes involving withdrawal liability

### *Present Law*

Under ERISA, when an employer withdraws from a multiemployer plan, the employer is generally liable for its share of unfunded vested benefits, determined as of the date of withdrawal (generally referred to as the "withdrawal liability"). Whether and when a withdrawal has occurred and the amount of the withdrawal liability is determined by the plan sponsor. The plan sponsor's assessment of withdrawal liability is presumed correct unless the employer shows by a preponderance of the evidence that the plan sponsor's determination of withdrawal liability was unreasonable or clearly erroneous. A similar standard applies in the event the amount of the plan's unfunded vested benefits is challenged.

The first payment of withdrawal liability determined by the plan sponsor is generally due no later than 60 days after demand, even if the employer contests the determination of liability. Disputes between an employer and plan sponsor concerning withdrawal liability are resolved through arbitration, which can be initiated by either party. Even if the employer contests the determination, payments of withdrawal liability must be made by the employer until the arbitrator issues a final decision with respect to the determination submitted for arbitration.

For purposes of withdrawal liability, all trades or businesses under common control are treated as a single employer. In addition, the plan sponsor may disregard a transaction in order to assess withdrawal liability if the sponsor determines that the principal purpose of the transaction was to avoid or evade withdrawal liability. For example, if a subsidiary of a parent company is sold and the subsidiary then withdraws from a multiemployer plan, the plan sponsor may assess withdrawal liability as if the subsidiary were still part of the parent company's controlled group if the sponsor determines that a principal purpose of the sale of the subsidiary was to evade or avoid withdrawal liability.

In the case of an employer that receives a notification of withdrawal liability and demand for payment after October 31, 2003, a special rule may apply if a transaction is disregarded by a plan sponsor in determining that a withdrawal has occurred or that an employer is liable for withdrawal liability. If the transaction that is disregarded by the plan sponsor occurred before January 1, 1999, and at least five years before the date of the withdrawal, then (1) the determination by the plan sponsor that a principal purpose of

the transaction was to evade or avoid withdrawal liability is not be presumed to be correct, (2) the plan sponsor, rather than the employer, has the burden to establish, by a preponderance of the evidence, the elements of the claim that a principal purpose of the transaction was to evade or avoid withdrawal liability, and (3) if an employer contests the plan sponsor's determination through an arbitration proceeding, or through a claim brought in a court of competent jurisdiction, the employer is not obligated to make any withdrawal liability payments until a final decision in the arbitration proceeding, or in court, upholds the plan sponsor's determination.

### *Explanation of Provision*

Under the provision, if (1) a plan sponsor determines that a complete or partial withdrawal of an employer has occurred or an employer is liable for withdrawal liability payments with respect to the complete or partial withdrawal from the plan and (2) such determination is based in whole or in part on a finding by the plan sponsor that a principal purpose of any transaction that occurred after December 31, 1998, and at least five years (two years in the case of a small employer) before the date of complete or partial withdrawal was to evade or avoid withdrawal liability, the person against which the withdrawal liability is assessed may elect to use a special rule relating to required payments. Under the special rule, if the electing person contests the plan sponsor's determination with respect to withdrawal liability payments through an arbitration proceeding, through a claim brought in a court of competent jurisdiction, or as otherwise permitted by law, the electing person is not obligated to make the withdrawal liability payments until a final decision in the arbitration proceeding, or in court, upholds the plan sponsor's determination. The special rule applies only if the electing person (1) provides notice to the plan sponsor of its election to apply the special rule within 90 days after the plan sponsor notifies the electing person of its liability, and (2) if a final decision on the arbitration proceeding, or in court, of the withdrawal liability dispute has not been rendered within 12 months from the date of such notice, the electing person provides to the plan, effective as of the first day following the 12-month period, a bond issued by a corporate surety, or an amount held on escrow by a bank or similar financial institution satisfactory to the plan, in an amount equal to the sum of the withdrawal liability payments that would otherwise be due for the 12-month period beginning with the first anniversary of such notice. The bond or escrow must remain in effect until there is a final decision in the arbitration proceeding, or in court, of the withdrawal liability dispute. At such time, the bond or escrow must be paid to the plan if the final decision upholds the plan sponsor's determination. If the withdrawal liability dispute is not concluded by 12 months after the electing person posts the bond or escrow, the electing person must, at the start of each succeeding 12-month period, provide an additional bond or amount held in escrow equal to the sum of the withdrawal liability payments that would otherwise be payable to the plan during that period.

A small employer is an employer which, for the calendar year in which the transaction occurred, and for each of the three preceding

years, on average (1) employs no more than 500 employees, and (2) is required to make contributions to the plan on behalf of not more than 250 employees.

### *Effective Date*

The provision is effective for any person that receives a notification of withdrawal liability and demand for payment on or after the date of enactment (August 17, 2006) with respect to a transaction that occurred after December 31, 1998.

## E. Prohibition on Retaliation against Employers Exercising their Rights to Petition the Federal Government (sec. 205 of the Act and sec. 510 of ERISA)

### *Present Law*

Under ERISA section 510, it is unlawful for any person to discharge, fine, suspend, expel, discipline, or discriminate against a participant or beneficiary for exercising any right to which he is entitled under the provisions of an employee benefit plan, Title I or section 3001 of ERISA, or for the purpose of interfering with the attainment of any right to which a participant may become entitled. It is also unlawful for any person to discharge, fine, suspend, expel or discriminate against any person because he has given information or has testified or is about to testify in any inquiry or proceeding relating to ERISA. The civil enforcement provisions under ERISA section 503 are applicable in the enforcement of such provisions.

### *Explanation of Provision*

The provision provides that in the case of a multiemployer plan, it is unlawful for the plan sponsor or any other person to discriminate against any contributing employer for exercising rights under ERISA or for giving information or testifying in an inquiry or proceedings relating to ERISA before Congress. The provision amends the anti-retaliation section of ERISA to provide protection for employers who contribute to multiemployer plans and others. The provision is intended to close a loophole in the existing whistleblower protections. In June 2005, a witness who appeared on behalf of several other companies testified before the Retirement Security & Aging Subcommittee of the Senate Health, Education, Labor & Pensions Committee. Subsequent to that testimony there was an allegation that some of these companies may have been targeted for possible audits.

It is intended that retaliation against any employer who has an obligation to contribute to a plan due to testifying before Congress or exercising his or her rights to petition for redress of grievances would amount to unlawful retaliation under ERISA as amended by the provision. Exercising rights under ERISA, testifying before Congress, and giving information in any inquiry or proceeding relating to this Act are intended to be protected under the provision.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## F. Special Rule for Certain Benefits Funded Under an Agreement Approved by the PBGC (sec. 206 of the Act)

### *Present Law*

No provision.

### *Explanation of Provision*

The provision provides that in the case of a multiemployer plan that is a party to an agreement that was approved by the PBGC before June 30, 2005, and that increases benefits and provides for special withdrawal liability rules, certain benefit increases funded pursuant to the agreement are not subject to the multiemployer plan funding rules under the provision (including the additional funding rules for plans in endangered or critical status) if the multiemployer plan is funded in compliance with the agreement (or any amendment thereto).

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## G. Exception from Excise Tax for Certain Multiemployer Pension Plans (sec. 214 of the Act)

### *Present Law*

If a multiemployer plan has an accumulated funding deficiency for a year, an excise tax of five percent generally applies, increasing to 100 percent if contributions sufficient to eliminate the funding deficiency are not made within a certain period.[501]

### *Explanation of Provision*

Under the provision, the present-law excise tax does not apply with respect to any accumulated funding deficiency of a multiemployer plan (1) with less than 100 participants; (2) with respect to which the contributing employers participated in a Federal fishery capacity reduction program; (3) with respect to which employers under the plan participated in the Northeast Fisheries Assistance Program; and (4) with respect to which the annual normal cost is less than $100,000 and the plan is experiencing a funding deficiency on the date of enactment (August 17, 2006). The tax does not apply to any taxable year beginning before the earlier of (1) the taxable year in which the plan sponsor adopts a rehabilitation plan, or (2) the taxable year that contains January 1, 2009.

[501] Code sec. 4971.

### *Effective Date*

The provision is effective for any taxable year beginning before the earlier of (1) the taxable year in which the plan sponsor adopts a rehabilitation plan, or (2) the taxable year that contains January 1, 2009.

## H. Sunset of Multiemployer Plan Funding Provisions (sec. 221 of the Act)

### *Present Law*

No provision.

### *Explanation of Provision*

The provision directs the Secretary of Labor, the Secretary of Treasury, and the Executive Director of the PBGC, not later than December 31, 2011, to conduct a study of the effect of the changes made by the provision on the operation and funding status of multiemployer plans and report the results of the study, including recommendations for legislation, to Congress. The study must include (1) the effect of funding difficulties, funding rules in effect before the date of enactment, and the changes made by the provision on small businesses participating in multiemployer plans; (2) the effect on the financial status of small employers of funding targets set in funding improvement and rehabilitation plans and associated contribution increases, funding deficiencies, excise taxes, withdrawal liability, the possibility of alternative schedules and procedures for financially-troubled employers, and other aspects of the multiemployer system; and (3) the role of the multiemployer pension plan system in helping small employers to offer pension benefits.

The provision provides that the rules applicable to plans in endangered and critical status and the shortfall funding method under the general funding rules for multiemployer plans do not apply to plan years beginning after December 31, 2014.[502] The present-law rules are reinstated for such years except that funding improvement and rehabilitation plans in effect at the time of the sunset continue.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

[502] As previously discussed, the rules relating to the automatic amortization extension do not apply with respect to any application submitted after December 31, 2014.

## TITLE III—INTEREST RATE ASSUMPTIONS

### A. Extension of Replacement of 30–Year Treasury Rates (sec. 301 of the Act, secs. 302 and 4006 of ERISA, and sec. 412 of the Code)

The provisions relating to extension of the replacement of the 30-year Treasury rate for purposes of single-employer funding rules are described above, under Title I. The provision relating to extension of the replacement of the 30-year Treasury rate for PBGC premium purposes is described below, under Title IV.

### B. Interest Rate Assumption for Determination of Lump-Sum Distributions (sec. 302 of the Act, sec. 205(g) of ERISA, and sec. 417(e) of the Code)

#### *Present Law*

Accrued benefits under a defined benefit pension plan generally must be paid in the form of an annuity for the life of the participant unless the participant consents to a distribution in another form. Defined benefit pension plans generally provide that a participant may choose among other forms of benefit offered under the plan, such as a lump-sum distribution. These optional forms of benefit generally must be actuarially equivalent to the life annuity benefit payable to the participant.

A defined benefit pension plan must specify the actuarial assumptions that will be used in determining optional forms of benefit under the plan in a manner that precludes employer discretion in the assumptions to be used. For example, a plan may specify that a variable interest rate will be used in determining actuarial equivalent forms of benefit, but may not give the employer discretion to choose the interest rate.

Statutory interest and mortality assumptions must be used in determining the minimum value of certain optional forms of benefit, such as a lump sum. That is, the lump sum payable under the plan may not be less than the amount of the lump sum that is actuarially equivalent to the life annuity payable to the participant, determined using the statutory assumptions. The statutory assumptions consist of an applicable interest rate and an applicable mortality table (as published by the IRS).

The applicable interest rate is the annual interest rate on 30–year Treasury securities for the month before the date of distribution or such other time as prescribed by Treasury regulations. The regulations provide various options for determining the interest rate to be used under the plan, such as the period for which the interest rate will remain constant ("stability period") and the use of averaging.

The applicable mortality table is a mortality table based on the 1994 Group Annuity Reserving Table ("94 GAR"), projected through 2002.

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant.[503] This restriction is sometimes referred to as the "anticutback" rule and applies to benefits that have already accrued. For purposes of the anticutback rule, an amendment is also treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit.

### *Explanation of Provision*

The provision changes the interest rate and mortality table used in calculating the minimum value of certain optional forms of benefit, such as lump sums.[504]

Minimum value is calculated using the first, second, and third segment rates as applied under the funding rules, with certain adjustments, for the month before the date of distribution or such other time as prescribed by Treasury regulations. The adjusted first, second, and third segment rates are derived from a corporate bond yield curve prescribed by the Secretary of the Treasury for such month which reflects the yields on investment grade corporate bonds with varying maturities (rather than a 24-month average, as under the minimum funding rules). Thus, the interest rate that applies depends upon how many years in the future a participant's annuity payment will be made. Typically, a higher interest rate applies for payments made further out in the future.

A transition rule applies with respect to interest rates used in determining distributions in plan years beginning in 2008 through 2011. Under the transition rule, for plan years beginning in 2008, the first, second, or third segment rate with respect to any month is the sum of: (1) the product of the segment rate otherwise determined for the month, multiplied by 20 percent; and (2) the product of the annual interest rate on 30-year Treasury securities determined for the month (i.e., the applicable interest rate under present law), multiplied by 80 percent. For plan years beginning in 2009, the first, second, or third segment rate with respect to any month is the sum of: (1) the product of the segment rate otherwise determined for the month, multiplied by 40 percent; and (2) the product of the annual interest rate on 30-year Treasury securities determined for the month, multiplied by 60 percent. For plan years beginning in 2010, the first, second, or third segment rate with respect to any month is the sum of: (1) the product of the segment rate otherwise determined for the month, multiplied by 60 percent; and (2) the product of the annual interest rate on 30-year Treasury securities determined for the month, multiplied by 40 percent. For plan years beginning in 2011, the first, second, or third segment

[503] Code sec. 411(d)(6); ERISA sec. 204(g).

[504] Under the provision of the Act relating to plan amendments, if certain requirements are met, a plan amendment to implement the changes made to the minimum value requirements may be made retroactively and without violating the anticutback rule.

rate with respect to any month is the sum of: (1) the product of the segment rate otherwise determined for the month, multiplied by 80 percent; and (2) the product of the annual interest rate on 30-year Treasury securities for the month, multiplied by 20 percent.

The mortality table that must be used for calculating lump sums under the Act is based on the mortality table required for minimum funding purposes under the Act, modified as appropriate by the Secretary of the Treasury. The Secretary is to prescribe gender-neutral tables for use in determining minimum lump sums.

### *Effective Date*

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

## C. Interest Rate Assumption for Applying Benefit Limitations to Lump-Sum Distributions (sec. 303 of the Act and sec. 415(b) of the Code)

### *Present Law*

Annual benefits payable under a defined benefit pension plan generally may not exceed the lesser of (1) 100 percent of average compensation, or (2) $175,000 (for 2006). The dollar limit generally applies to a benefit payable in the form of a straight life annuity. If the benefit is not in the form of a straight life annuity (e.g., a lump sum), the benefit generally is adjusted to an equivalent straight life annuity. For purposes of adjusting a benefit in a form that is subject to the minimum value rules, such as a lump-sum benefit, the interest rate used generally must be not less than the greater of: (1) the rate applicable in determining minimum lump sums, i.e., the interest rate on 30-year Treasury securities; or (2) the interest rate specified in the plan. In the case of plan years beginning in 2004 or 2005, the interest rate used generally must be not less than the greater of: (1) 5.5 percent; or (2) the interest rate specified in the plan.[505]

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant.[506] This restriction is sometimes referred to as the "anticutback" rule and applies to benefits that have already accrued. For purposes of the anticutback rule, an amendment is also treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit.

---

[505] In the case of a plan under which lump-sum benefits are determined solely as required under the minimum value rules (rather than using an interest rate that results in larger lump-sum benefits), the interest rate specified in the plan is the interest rate applicable under the minimum value rules. Thus, for purposes of applying the benefit limits to lump-sum benefits under the plan, the interest rate used must be not less than the greater of: (1) 5.5 percent; or (2) the interest rate applicable under the minimum value rules.

[506] Code sec. 411(d)(6); ERISA sec. 204(g).

### *Explanation of Provision*

Under the Act, for purposes of adjusting a benefit in a form that is subject to the minimum value rules, such as a lump-sum benefit, the interest rate used generally must be not less than the greater of: (1) 5.5 percent; (2) the rate that provides a benefit of not more than 105 percent of the benefit that would be provided if the rate (or rates) applicable in determining minimum lump sums were used; or (3) the interest rate specified in the plan.[507]

### *Effective Date*

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

[507] Under the provision of the Act relating to plan amendments, if certain requirements are met, a plan amendment to implement the change made to the interest rate used in adjusting a benefit in a form that is subject to the minimum value rules may be made retroactively and without violating the anticutback rule.

# TITLE IV—PBGC GUARANTEE AND RELATED PROVISIONS

## A. PBGC Premiums (secs. 301 and 401 of the Act and sec. 4006 of ERISA)

### *Present Law*

#### *The PBGC*

The minimum funding requirements permit an employer to fund defined benefit plan benefits over a period of time. Thus, it is possible that a plan may be terminated at a time when plan assets are not sufficient to provide all benefits accrued by employees under the plan. In order to protect plan participants from losing retirement benefits in such circumstances, the Pension Benefit Guaranty Corporation ("PBGC"), a corporation within the Department of Labor, was created in 1974 under ERISA to provide an insurance program for benefits under most defined benefit plans maintained by private employers.

#### *Termination of single-employer defined benefit plans*

An employer may voluntarily terminate a single-employer plan only in a standard termination or a distress termination. The PBGC may also involuntarily terminate a plan (that is, the termination is not voluntary on the part of the employer).

A standard termination is permitted only if plan assets are sufficient to cover benefit liabilities. If assets in a defined benefit plan are not sufficient to cover benefit liabilities, the employer may not terminate the plan unless the employer (and members of the employer's controlled group) meets one of four criteria of financial distress.[508]

The PBGC may institute proceedings to terminate a plan if it determines that the plan in question has not met the minimum funding standards, will be unable to pay benefits when due, has a substantial owner who has received a distribution greater than $10,000 (other than by reason of death) while the plan has unfunded nonforfeitable benefits, or may reasonably be expected to increase PBGC's long-run loss unreasonably. The PBGC must institute proceedings to terminate a plan if the plan is unable to pay benefits that are currently due.

[508] The four criteria for a distress termination are: (1) the contributing sponsor, and every member of the controlled group of which the sponsor is a member, is being liquidated in bankruptcy or any similar Federal law or other similar State insolvency proceedings; (2) the contributing sponsor and every member of the sponsor's controlled group is being reorganized in bankruptcy or similar State proceeding; (3) the PBGC determines that termination is necessary to allow the employer to pay its debts when due; or (4) the PBGC determines that termination is necessary to avoid unreasonably burdensome pension costs caused solely by a decline in the employer's work force.

### *Guaranteed benefits*

When an underfunded plan terminates, the amount of benefits that the PBGC will pay depends on legal limits, asset allocation, and recovery on the PBGC's employer liability claim. The PBGC guarantee applies to "basic benefits." Basic benefits generally are benefits accrued before a plan terminates, including (1) benefits at normal retirement age; (2) most early retirement benefits; (3) disability benefits for disabilities that occurred before the plan was terminated; and (4) certain benefits for survivors of plan participants. Generally only that part of the retirement benefit that is payable in monthly installments (rather than, for example, lump-sum benefits payable to encourage early retirement) is guaranteed.[509]

Retirement benefits that begin before normal retirement age are guaranteed, provided they meet the other conditions of guarantee (such as that before the date the plan terminates, the participant had satisfied the conditions of the plan necessary to establish the right to receive the benefit other than application for the benefit). Contingent benefits (for example, subsidized early retirement benefits) are guaranteed only if the triggering event occurs before plan termination.

For plans terminating in 2006, the maximum guaranteed benefit for an individual retiring at age 65 and receiving a single life annuity is $3,971.59 per month or $47,659.08 per year.[510] The dollar limit is indexed annually for inflation. The guaranteed amount is reduced for benefits starting before age 65.

In the case of a plan or a plan amendment that has been in effect for less than five years before a plan termination, the amount guaranteed is phased in by 20 percent a year.[511]

### *PBGC premiums*

#### *In general*

The PBGC is funded by assets in terminated plans, amounts recovered from employers who terminate underfunded plans, premiums paid with respect to covered plans, and investment earnings. All covered single-employer plans are required to pay a flat per-participant premium and underfunded plans are subject to an additional variable rate premium based on the level of underfunding. The amount of both the flat rate premium and the variable rate premium are set by statute; the premiums are not indexed for inflation.

---

[509] ERISA sec. 4022(b) and (c).

[510] The PBGC generally pays the greater of the guaranteed benefit amount and the amount that was covered by plan assets when it terminated. Thus, depending on the amount of assets in the terminating plan, participants may receive more than the amount guaranteed by PBGC.

Special rules limit the guaranteed benefits of individuals who are substantial owners covered by a plan whose benefits have not been increased by reason of any plan amendment. A substantial owner generally is an individual who: (1) owns the entire interest in an unincorporated trade or business; (2) in the case of a partnership, is a partner who owns, directly or indirectly, more than 10 percent of either the capital interest or the profits interest in the partnership; (3) in the case of a corporation, owns, directly or indirectly, more than 10 percent in value of either the voting stock of the corporation or all the stock of the corporation; or (4) at any time within the preceding 60 months was a substantial owner under the plan. ERISA sec. 4022(b)(5).

[511] The phase in does not apply if the benefit is less than $20 per month.

*Flat rate premium*

Under the Deficit Reduction Act of 2005,[512] the flat-rate premium is $30 for plan years beginning after December 31, 2005, with indexing after 2006 based on increases in average wages.

*Variable rate premium*

The variable rate premium is equal to $9 per $1,000 of unfunded vested benefits. "Unfunded vested benefits" is the amount which would be the unfunded current liability (as defined under the minimum funding rules) if only vested benefits were taken into account and if benefits were valued at the variable premium interest rate. No variable rate premium is imposed for a year if contributions to the plan for the prior year were at least equal to the full funding limit for that year.

In determining the amount of unfunded vested benefits, the interest rate used is generally 85 percent of the interest rate on 30 year Treasury securities for the month preceding the month in which the plan year begins (100 percent of the interest rate on 30 year Treasury securities for plan years beginning in 2002 and 2003). Under the Pension Funding Equity Act of 2004, in determining the amount of unfunded vested benefits for plan years beginning after December 31, 2003, and before January 1, 2006, the interest rate used is 85 percent of the annual rate of interest determined by the Secretary of the Treasury on amounts invested conservatively in long term investment-grade corporate bonds for the month preceding the month in which the plan year begins.

*Termination premium*

Under the Deficit Reduction Act of 2005, a new premium generally applies in the case of certain plan terminations occurring after 2005 and before 2011. A premium of $1,250 per participant is imposed generally for the year of the termination and each of the following two years. The premium applies in the case of a plan termination by the PBGC or a distress termination due to reorganization in bankruptcy, the inability of the employer to pay its debts when due, or a determination that a termination is necessary to avoid unreasonably burdensome pension costs caused solely by a decline in the workforce. In the case of a termination due to reorganization, the liability for the premium does not arise until the employer is discharged from the reorganization proceeding. The premium does not apply with respect to a plan terminated during bankruptcy reorganization proceedings pursuant to a bankruptcy filing before October 18, 2005.

## *Explanation of Provision*

### *Variable rate premium*

For 2006 and 2007, the Act extends the present-law rule under which, in determining the amount of unfunded vested benefits for variable rate premium purposes, the interest rate used is 85 percent of the annual rate of interest determined by the Secretary of the Treasury on amounts invested conservatively in long term in-

[512] Pub. L. No. 109–171, enacted February 8, 2006.

vestment-grade corporate bonds for the month preceding the month in which the plan year begins.

Beginning in 2008, the determination of unfunded vested benefits for purposes of the variable rate premium is modified to reflect the changes to the funding rules of the provision. Thus, under the provision, unfunded vested benefits are equal to the excess (if any) of (1) the plan's funding target[513] for the year determined as under the minimum funding rules, but taking into account only vested benefits over (2) the fair market value of plan assets. In valuing unfunded vested benefits the interest rate is the first, second, and third segment rates which would be determined under the funding rules of the provision, if the segment rates were based on the yields of corporate bond rates, rather than a 24-month average of such rates. Under the Act, deductible contributions are no longer limited by the full funding limit; thus, the rule providing that no variable rate premium is required if contributions for the prior plan year were at least equal to the full funding limit no longer applies under the provision.

### *Termination premium*

The Act makes permanent the termination premium enacted in the Deficit Reduction Act of 2005.

### *Effective Date*

The extension of the present-law interest rate for purposes of calculating the variable rate premium is effective for plan years beginning in 2006 and 2007. The modifications to the variable rate premium are effective for plan years beginning after December 31, 2007. The provision extending the termination premium is effective on the date of enactment (August 17, 2006).

## B. Special Funding Rules for Plans Maintained by Commercial Airlines (sec. 402 of the Act)

### *Present Law*

### *Minimum funding rules in general*

Single-employer defined benefit pension plans are subject to minimum funding requirements under the Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code (the "Code").[514] The amount of contributions required for a plan year under the minimum funding rules is generally the amount needed to fund benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit. The amount of required annual contributions is determined under one of a number of acceptable actuarial cost methods. Additional contributions are required under the deficit reduction contribution rules in the case of certain underfunded plans. No con-

[513] The assumptions used in determining funded target are the same as under the minimum funding rules. Thus, for a plan in at-risk status, the at-risk assumptions are used.

[514] Code sec. 412. The minimum funding rules also apply to multiemployer plans, but the rules for multiemployer plans differ in various respects from the rules applicable to single-employer plans.

tribution is required under the minimum funding rules in excess of the full funding limit. A detailed description of the present-law funding rules is provided in Title I, above.

### *Notice of certain plan amendments*

A notice requirement must be met if an amendment to a defined benefit pension plan provides for a significant reduction in the rate of future benefit accrual. In that case, the plan administrator must furnish a written notice concerning the amendment. Notice may also be required if a plan amendment eliminates or reduces an early retirement benefit or retirement-type subsidy. The plan administrator is required to provide the notice to any participant or alternate payee whose rate of future benefit accrual may reasonably be expected to be significantly reduced by the plan amendment (and to any employee organization representing affected participants). The notice must be written in a manner calculated to be understood by the average plan participant and must provide sufficient information to allow recipients to understand the effect of the amendment. In the case of a single-employer plan, the plan administrator is generally required to provide the notice at least 45 days before the effective date of the plan amendment. In the case of a multiemployer plan, the notice is generally required to be provided 15 days before the effective date of the plan amendment.

### *PBGC termination insurance program*

The minimum funding requirements permit an employer to fund defined benefit plan benefits over a period of time. Thus, it is possible that a plan may be terminated at a time when plan assets are not sufficient to provide all benefits accrued by employees under the plan. In order to protect plan participants from losing retirement benefits in such circumstances, the PBGC guarantees basic benefits under most defined benefit plans. When an underfunded plan terminates, the amount of benefits that the PBGC will pay depends on legal limits, asset allocation, and recovery on the PBGC's employer liability claim. There is a dollar limit on the amount of otherwise guaranteed benefits based on the year in which the plan terminates. For plans terminating in 2006, the maximum guaranteed benefit for an individual retiring at age 65 and receiving a single life annuity is $3,971.59 per month or $47,659.08 per year.[515] The dollar limit is indexed annually for inflation. The guaranteed amount is reduced for benefits starting before age 65. In the case of a plan or a plan amendment that has been in effect for less than five years before a plan termination, the amount guaranteed is phased in by 20 percent a year.[516]

---

[515] The PBGC generally pays the greater of the guaranteed benefit amount and the amount that was covered by plan assets when it terminated. Thus, depending on the amount of assets in the terminating plan, participants may receive more than the amount guaranteed by PBGC.

Special rules limit the guaranteed benefits of individuals who are substantial owners covered by a plan whose benefits have not been increased by reason of any plan amendment. A substantial owner generally is an individual who: (1) owns the entire interest in an unincorporated trade or business; (2) in the case of a partnership, is a partner who owns, directly or indirectly, more than 10 percent of either the capital interest or the profits interest in the partnership; (3) in the case of a corporation, owns, directly or indirectly, more than 10 percent in value of either the voting stock of the corporation or all the stock of the corporation; or (4) at any time within the preceding 60 months was a substantial owner under the plan.

[516] The phase in does not apply if the benefit is less than $20 per month.

***Termination premiums***

Under the Deficit Reduction Act of 2005, a new premium generally applies in the case of certain plan terminations occurring after 2005 and before 2011. A premium of $1,250 per participant is imposed generally for the year of the termination and each of the following two years. The premium applies in the case of a plan termination by the PBGC or a distress termination due to reorganization in bankruptcy, the inability of the employer to pay its debts when due, or a determination that a termination is necessary to avoid unreasonably burdensome pension costs caused solely by a decline in the workforce. In the case of a termination due to reorganization, the liability for the premium does not arise until the employer is discharged from the reorganization proceeding. The premium does not apply with respect to a plan terminated during bankruptcy reorganization proceedings pursuant to a bankruptcy filing before October 18, 2005.

***Minimum coverage requirements***

The Code imposes minimum coverage requirements on qualified retirement plans in order to ensure that plans cover a broad cross section of employees.[517] In general, the minimum coverage requirements are satisfied if one of the following criteria are met: (1) the plan benefits at least 70 percent of employees who are not highly compensated employees; (2) the plan benefits a percentage of employees who are not highly compensated employees which is at least 70 percent of the percentage of highly compensated employees participating under the plan; or (3) the plan meets the average benefits test.

Certain employees may be disregarded in applying the minimum coverage requirements. Under one exclusion, in the case of a plan established or maintained pursuant to an agreement which the Secretary of Labor finds to be a collective bargaining agreement between air pilots represented in accordance with title II of the Railway Labor Act and one or more employers, all employees not covered by such agreement may be disregarded. This exclusion does not apply in the case of a plan which provides contributions or benefits for employees whose principal duties are not customarily performed aboard aircraft in flight.

***Alternative deficit reduction contribution for certain plans***

Under present law, certain employers ("applicable employers") may elect a reduced amount of additional required contribution under the deficit reduction contribution rules (an "alternative deficit reduction contribution") with respect to certain plans for applicable plan years. An applicable plan year is a plan year beginning after December 27, 2003, and before December 28, 2005, for which the employer elects a reduced contribution. If an employer so elects, the amount of the additional deficit reduction contribution for an applicable plan year is the greater of: (1) 20 percent of the amount of the additional contribution that would otherwise be required; or (2) the additional contribution that would be required if the deficit reduction contribution for the plan year were determined

[517] Code sec. 410(b).

as the expected increase in current liability due to benefits accruing during the plan year.

An applicable employer is an employer that is: (1) a commercial passenger airline; (2) primarily engaged in the production or manufacture of a steel mill product, or the processing of iron ore pellets; or (3) an organization described in section 501(c)(5) that established the plan for which an alternative deficit reduction contribution is elected on June 30, 1955.

### *Explanation of Provision*

#### *In general*

The provision provides special funding rules for certain eligible plans. For purposes of the provision, an eligible plan is a single-employer defined benefit pension plan sponsored by an employer that is a commercial passenger airline or the principal business of which is providing catering services to a commercial passenger airline.

The plan sponsor of an eligible plan may make one of two alternative elections. In the case of a plan that meets certain benefit accrual and benefit increase restrictions, an election allowing a 17-year amortization of the plan's unfunded liability is available. A plan that does not meet such requirements may elect to use a 10-year amortization period in amortizing the plan's shortfall amortization base for the first taxable year beginning in 2008.

#### *Election for plans that meet benefit accrual and benefit increase restriction requirements*

##### *In general*

Under the provision, if an election of a 17-year amortization period is made with respect to an eligible plan for a plan year (an "applicable" plan year), the minimum required contribution is determined under a special method.[518] If minimum required contributions as determined under the provision are made: (1) for an applicable plan year beginning before January 1, 2008 (for which the present-law funding rules apply), the plan does not have an accumulated funding deficiency; and (2) for an applicable plan year beginning on or after January 1, 2008 (for which the funding rules under the provision apply), the minimum required contribution is the contribution determined under the provision.

The employer may select either a plan year beginning in 2006 or 2007 as the first plan year to which the election applies. The election applies to such plan year and all subsequent plan years, unless the election is revoked with the approval of the Secretary of the Treasury. The election must be made (1) no later than December 31, 2006, in the case of an election for a plan year beginning in 2006, or (2) not later than December 31, 2007, in the case of a plan year beginning in 2007. An election under the provision must be made in such manner as prescribed by the Secretary of the Treasury. The employer may change the plan year with respect to

[518] Any charge or credit in the funding standard account determined under the present-law rules or any prefunding balance or funding standard carryover balance (determined under the funding provisions of the Act) as of the end of the last year preceding the first applicable year is reduced to zero.

the plan by specifying a new plan year in the election. Such a change in plan year does not require approval of the Secretary of the Treasury.

*Determination of required contribution*

Under the provision, the minimum required contribution for any applicable plan year during the amortization period is the amount required to amortize the plan's unfunded liability, determined as of the first day of the plan year, in equal annual installments over the remaining amortization period. For this purpose, the amortization period is the 17-plan-year period beginning with the first applicable plan year. Thus, the annual amortization amount is redetermined each year, based on the plan's unfunded liability at that time and the remainder of the amortization period. For any plan years beginning after the end of the amortization period, the plan is subject to the generally applicable minimum funding rules (as provided under the Act, including the benefit limitations applicable to underfunded plans). The plan's prefunding balance and funding standard carryover balance as of the first day of the first year beginning after the end of the amortization period are zero.[519]

Any waived funding deficiency as of the day before the first day of the first applicable plan year is deemed satisfied and the amount of such waived funding deficiency must be taken into account in determining the plan's unfunded liability under the provision. Any plan amendment adopted to satisfy the benefit accrual restrictions of the provision (discussed below) or any increase in benefits provided to such plan's participants under a defined contribution or multiemployer plan will not be deemed to violate the prohibition against benefit increases during a waiver period.[520]

For purposes of the provision, a plan's unfunded liability is the unfunded accrued liability under the plan, determined under the unit credit funding method. As under present law, minimum required contributions (including the annual amortization amount) under the provision must be determined using actuarial assumptions and methods, each of which is reasonable (taking into account the experience of the plan and reasonable expectations), or which, in the aggregate, result in a total plan contribution equivalent to a contribution that would be obtained if each assumption and method were reasonable. The assumptions are required also to offer the actuary's best estimate of anticipated experience under the plan. Under the election, a rate of interest of 8.85 percent is used in determining the plan's accrued liability. The value of plan assets used must be the fair market value.

If any applicable plan year with respect to an eligible plan using the special method includes the date of enactment of the provision (August 17, 2006) and a plan was spun off from such eligible plan during the plan year, but before the date of enactment, the minimum required contribution under the special method for the applicable plan year is an aggregate amount determined as if the plans

[519] If an election to use the special method is revoked before the end of the amortization period, the plan is subject to the generally applicable minimum funding rules beginning with the first plan year for which the election is revoked, and the plan's prefunding balance as of the beginning of that year is zero.

[520] ERISA sec. 304(b); Code sec. 412(f).

were a single plan for that plan year (based on the full 12-month plan year in effect prior to the spin off). The employer is to designate the allocation of the aggregate amount between the plans for the applicable plan year.

*Benefit accrual and benefit increase restrictions*

*Benefit accrual restrictions.*—Under the provision, effective as of the first day of the first applicable plan year and at all times thereafter while an election under the provision is in effect, an eligible plan must include two accrual restrictions. First, the plan must provide that, with respect to each participant: (1) the accrued benefit, any death or disability benefit, and any social security supplement are frozen at the amount of the benefit or supplement immediately before such first day; and (2) all other benefits under the plan are eliminated. However, such freezing or elimination of benefits or supplements is required only to the extent that it would be permitted under the anticutback rule if implemented by a plan amendment adopted immediately before such first day.

Second, if an accrued benefit of a participant has been subject to the limitations on benefits under section 415 of the Code and would otherwise be increased if such limitation is increased, the plan must provide that, effective as of the first day of the first applicable plan year (or, if later, the date of enactment) any such increase will not take effect. The plan does not fail to meet the anticutback rule solely because the plan is amended to meet this requirement.

*Benefit increase restriction.*—No applicable benefit increase under an eligible plan may take effect at any time during the period beginning on July 26, 2005, and ending on the day before the first day of the first applicable plan year. For this purpose, an applicable benefit increase is any increase in liabilities of the plan by plan amendment (or otherwise as specified by the Secretary) which would occur by reason of: (1) any increase in benefits; (2) any change in the accrual of benefits; or (3) any change in the rate at which benefits become nonforfeitable under the plan.

*Exception for imputed disability service.*—The benefit accrual and benefit increase restrictions do not apply to any accrual or increase with respect to imputed serviced provided to a participant during any period of the participant's disability occurring on or after the effective date of the plan amendment providing for the benefit accrual restrictions (on or after July 26, 2005, in the case of benefit increase restrictions) if the participant: (1) was receiving disability benefits as of such date or (2) was receiving sick pay and subsequently determined to be eligible for disability benefits as of such date.

*Rules relating to PBGC guarantee and plan terminations*

Under the provision, if a plan to which an election applies is terminated before the end of the 10-year period beginning on the first day of the first applicable plan year, certain aspects of the PBGC guarantee provisions are applied as if the plan terminated on the first day of the first applicable plan year. Specifically, the amount of guaranteed benefits payable by the PBGC is determined based on plan assets and liabilities as of the assumed termination date. The difference between the amount of guaranteed benefits deter-

mined as of the assumed termination date and the amount of guaranteed benefits determined as of the actual termination date is to be paid from plan assets before other benefits.

The provision of the Act under which defined benefit plans that are covered by the PBGC insurance program are not taken into account in applying the overall limit on deductions for contributions to combinations of defined benefit and defined contribution plans, does not apply to an eligible plan to which the special method applies. Thus, the overall deduction limit applies.

In the case of notice required with respect to an amendment that is made to an eligible plan maintained pursuant to one or more collective bargaining agreements in order to comply with the benefit accrual and benefit increase restrictions under the provision, the provision allows the notice to be provided 15 days before the effective date of the plan amendment.

*Termination premiums*

If a plan terminates during the five-year period beginning on the first day of the first applicable plan year, termination premiums are imposed at a rate of $2,500 per participant (in lieu of the present-law $1,250 amount). The increased termination premium applies notwithstanding that a plan was terminated during bankruptcy reorganization proceedings pursuant to a bankruptcy filing before October 18, 2005 (i.e., the present-law grandfather rule does not apply).

The Secretary of Labor may waive the additional termination premium if the Secretary determines that the termination occurred as the result of extraordinary circumstances such as a terrorist attack or other similar event. It is intended that extraordinary circumstances means a substantial, system-wide adverse effect on the airline industry such as the terrorist attack which occurred on September 11, 2001. It is intended that the waiver of the additional premiums occur only in rare and unpredictable events. Extraordinary circumstances would not include a mere economic event such as the high price of oil or fuel, or a downturn in the market.

***Alternative election in the case of plans not meeting benefit accrual and benefit increase restrictions***

In lieu of the election above, a plan sponsor may elect, for the first taxable year beginning in 2008, to amortize the shortfall amortization base for such taxable year over a period of 10 plan years (rather than seven plan years) beginning with such plan year. Under such election, the benefit accrual, benefit increase and other restrictions discussed above do not apply. This 10-year amortization election must be made by December 31, 2007.

***Authority of Treasury to disqualify successor plans***

If either election is made under the provision and the eligible plan is maintained by an employer that establishes or maintains one or more other single-employer defined benefit plans, and such other plans in combination provide benefit accruals to any substantial number of successor employees, the Secretary of Treasury may disqualify such successor plans unless all benefit obligations of the eligible plan have been satisfied. Successor employees include any

employee who is or was covered by the eligible plan and any employee who performs substantially the same type of work with respect to the same business operations as an employee covered by the eligible plan.

***Alternative deficit reduction contribution for certain plans***

In the case of an employer which is a commercial passenger airline, the provision extends the alternative deficit reduction contributions rules to plan years beginning before December 28, 2007.

***Application of minimum coverage rules***

In applying the minimum coverage rules to a plan, management pilots who are not represented in accordance with title II of the Railway Labor Act are treated as covered by a collective bargaining agreement if the management pilots manage the flight operations of air pilots who are so represented and the management pilots are, pursuant to the terms of the agreement, included in the group of employees benefiting under the plan.

The exclusion under the minimum coverage rules for air pilots represented in accordance with title II of the Railway Labor Act does not apply in the case of a plan which provides contributions or benefits for employees whose principal duties are not customarily performed aboard an aircraft in flight (other than management pilots described above).

### *Effective Date*

The provision is effective for plan years ending after the date of enactment (August 17, 2006) except that the modifications to the minimum coverage rules apply to years beginning before, on, or after the date of enactment.

## C. Limitations on PBGC Guarantee of Shutdown and Other Benefits (sec. 403 of the Act and sec. 4022 of ERISA)

### *Present Law*

A plan may provide for unpredictable contingent event benefits, which are benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce. Under present law, unpredictable contingent event benefits generally are not taken into account for funding purposes until the event has occurred.

Under present law, defined benefit pension plans are not permitted to provide "layoff" benefits (i.e., severance benefits).[521] However, defined benefit pension plans may provide subsidized early retirement benefits, including early retirement window benefits.[522]

Within certain limits, the PBGC guarantees any retirement benefit that was vested on the date of plan termination (other than benefits that vest solely on account of the termination), and any survivor or disability benefit that was owed or was in payment sta-

[521] Treas. Reg. sec. 1.401–1(b)(1)(i).
[522] Treas. Reg. secs. 1.401(a)(4)–3(f)(4) and 1.411(a)–7(c).

tus at the date of plan termination.[523] Generally only that part of the retirement benefit that is payable in monthly installments is guaranteed.[524]

Retirement benefits that begin before normal retirement age are guaranteed, provided they meet the other conditions of guarantee (such as that, before the date the plan terminates, the participant had satisfied the conditions of the plan necessary to establish the right to receive the benefit other than application for the benefit). Contingent benefits (for example, early retirement benefits provided only if a plant shuts down) are guaranteed only if the triggering event occurs before plan termination.

In the case of a plan or a plan amendment that has been in effect for less than five years before a plan termination, the amount guaranteed is phased in by 20 percent a year.

### *Explanation of Provision*

Under the Act, the PBGC guarantee applies to unpredictable contingent event benefits as if a plan amendment had been adopted on the date the event giving rise to the benefits occurred. An unpredictable contingent event benefit is defined as under the benefit limitations applicable to single-employer plans (described above) and means a benefit payable solely by reason of (1) a plant shutdown (or similar event as determined by the Secretary of the Treasury), or (2) an event other than the attainment of any age, performance of any service, receipt or derivation of any compensation, or occurrence of death or disability.

### *Effective Date*

The provision applies to benefits that become payable as a result of an event which occurs after July 26, 2005.

## D. Rules Relating to Bankruptcy of the Employer (sec. 404 of the Act and secs. 4022 and 4044 of ERISA)

### *Present Law*

#### *Guaranteed benefits*

When an underfunded plan terminates, the amount of benefits that the PBGC will pay depends on legal limits, asset allocation, and recovery on the PBGC's employer liability claim. The PBGC guarantee applies to "basic benefits." Basic benefits generally are benefits accrued before a plan terminates, including (1) benefits at normal retirement age; (2) most early retirement benefits; (3) disability benefits for disabilities that occurred before the plan was terminated; and (4) certain benefits for survivors of plan participants. Generally only that part of the retirement benefit that is payable in monthly installments is guaranteed.[525]

Retirement benefits that begin before normal retirement age are guaranteed, provided they meet the other conditions of guarantee (such as that before the date the plan terminates, the participant

[523] ERISA sec. 4022(a).
[524] ERISA sec. 4022(b) and (c).
[525] ERISA sec. 4022(b) and (c).

had satisfied the conditions of the plan necessary to establish the right to receive the benefit other than application for the benefit). Contingent benefits (for example, subsidized early retirement benefits) are guaranteed only if the triggering event occurs before plan termination.

For plans terminating in 2006, the maximum guaranteed benefit for an individual retiring at age 65 and receiving a single life annuity is $3,971.59 per month or $47,659.08 per year.[526] The dollar limit is indexed annually for inflation. The guaranteed amount is reduced for benefits starting before age 65.

In the case of a plan or a plan amendment that has been in effect for less than five years before a plan termination, the amount guaranteed is phased in by 20 percent a year.[527]

### *Asset allocation*

ERISA contains rules for allocating the assets of a single-employer plan when the plan terminates. Plan assets available to pay for benefits under a terminating plan include all plan assets remaining after subtracting all liabilities (other than liabilities for future benefit payments), paid or payable from plan assets under the provisions of the plan. On termination, the plan administrator must allocate plan assets available to pay for benefits under the plan in the manner prescribed by ERISA. In general, plan assets available to pay for benefits under the plan are allocated to six priority categories. If the plan has sufficient assets to pay for all benefits in a particular priority category, the remaining assets are allocated to the next lower priority category. This process is repeated until all benefits in the priority categories are provided or until all available plan assets have been allocated.

## *Explanation of Provision*

Under the Act, the amount of guaranteed benefits payable by the PBGC is frozen when a contributing sponsor enters bankruptcy or a similar proceeding.[528] If the plan terminates during the contributing sponsor's bankruptcy, the amount of guaranteed benefits payable by the PBGC is determined based on plan provisions, salary, service, and the guarantee in effect on the date the employer entered bankruptcy. The priority among participants for purposes of allocating plan assets and employer recoveries to non-guaranteed benefits in the event of plan termination is determined as of the date the sponsor enters bankruptcy or a similar proceeding.

---

[526] The PBGC generally pays the greater of the guaranteed benefit amount and the amount that was covered by plan assets when it terminated. Thus, depending on the amount of assets in the terminating plan, participants may receive more than the amount guaranteed by PBGC.

Special rules limit the guaranteed benefits of individuals who are substantial owners covered by a plan whose benefits have not been increased by reason of any plan amendment. A substantial owner generally is an individual who: (1) owns the entire interest in an unincorporated trade or business; (2) in the case of a partnership, is a partner who owns, directly or indirectly, more than 10 percent of either the capital interest or the profits interest in the partnership; (3) in the case of a corporation, owns, directly or indirectly, more than 10 percent in value of either the voting stock of the corporation or all the stock of the corporation; or (4) at any time within the preceding 60 months was a substantial owner under the plan. ERISA sec. 4022(b)(5).

[527] The phase in does not apply if the benefit is less than $20 per month.

[528] For purposes of the provision, a contributing sponsor is considered to have entered bankruptcy if the sponsor files or has had filed against it a petition seeking liquidation or reorganization in a case under title 11 of the United States Code or under any similar Federal law or law of a State or political subdivision.

### *Effective Date*

The provision is effective with respect to Federal bankruptcy or similar proceedings or arrangements for the benefit of creditors which are initiated on or after the date that is 30 days after enactment.

## E. PBGC Variable Rate Premiums for Small Plans (sec. 405 of the Act and sec. 4006 of ERISA)

### *Present Law*

Under present law, the Pension Benefit Guaranty Corporation ("PBGC") provides insurance protection for participants and beneficiaries under certain defined benefit pension plans by guaranteeing certain basic benefits under the plan in the event the plan is terminated with insufficient assets to pay benefits promised under the plan. The guaranteed benefits are funded in part by premium payments from employers who sponsor defined benefit pension plans. The amount of the required annual PBGC premium for a single-employer plan is generally a flat rate premium of $19 per participant and an additional variable-rate premium based on a charge of $9 per $1,000 of unfunded vested benefits. Unfunded vested benefits under a plan generally means (1) the unfunded current liability for vested benefits under the plan, over (2) the value of the plan's assets, reduced by any credit balance in the funding standard account. No variable-rate premium is imposed for a year if contributions to the plan were at least equal to the full funding limit.

The PBGC guarantee is phased in ratably in the case of plans that have been in effect for less than five years, and with respect to benefit increases from a plan amendment that was in effect for less than five years before termination of the plan.

### *Explanation of Provision*

In the case of a plan of a small employer, the per participant variable-rate premium is no more than $5 multiplied by the number of plan participants in the plan at the end of the preceding plan year. For purposes of the provision, a small employer is a contributing sponsor that, on the first day of the plan year, has 25 or fewer employees. For this purpose, all employees of the members of the controlled group of the contributing sponsor are to be taken into account. In the case of a plan to which more than one unrelated contributing sponsor contributed, employees of all contributing sponsors (and their controlled group members) are to be taken into account in determining whether the plan was a plan of a small employer. For example, under the provision, in the case of a plan with 20 participants, the total variable rate premium is not more than $2,000, that is, $(20 \times \$5) \times 20$.

### *Effective Date*

The provision applies to plan years beginning after December 31, 2006.

## F. Authorization for PBGC to Pay Interest on Premium Overpayment Refunds (sec. 406 of the Act and sec. 4007(b) of ERISA)

### *Present Law*

The PBGC charges interest on underpayments of premiums, but is not authorized to pay interest on overpayments.

### *Explanation of Provision*

The provision allows the PBGC to pay interest on overpayments made by premium payors. Interest paid on overpayments is to be calculated at the same rate and in the same manner as interest charged on premium underpayments.

### *Effective Date*

The provision is effective with respect to interest accruing for periods beginning not earlier than the date of enactment (August 17, 2006).

## G. Rules for Substantial Owner Benefits in Terminated Plans (sec. 407 of the Act and secs. 4021, 4022, 4043, and 4044 of ERISA)

### *Present Law*

Under present law, the Pension Benefit Guaranty Corporation ("PBGC") provides participants and beneficiaries in a defined benefit pension plan with certain minimal guarantees as to the receipt of benefits under the plan in case of plan termination. The employer sponsoring the defined benefit pension plan is required to pay premiums to the PBGC to provide insurance for the guaranteed benefits. In general, the PBGC will guarantee all basic benefits which are payable in periodic installments for the life (or lives) of the participant and his or her beneficiaries and are non-forfeitable at the time of plan termination. The amount of the guaranteed benefit is subject to certain limitations. One limitation is that the plan (or an amendment to the plan which increases benefits) must be in effect for 60 months before termination for the PBGC to guarantee the full amount of basic benefits for a plan participant, other than a substantial owner. In the case of a substantial owner, the guaranteed basic benefit is phased in over 30 years beginning with participation in the plan. A substantial owner is one who owns, directly or indirectly, more than 10 percent of the voting stock of a corporation or all the stock of a corporation. Special rules restricting the amount of benefit guaranteed and the allocation of assets also apply to substantial owners.

### *Explanation of Provision*

The provision provides that the 60-month phase-in of guaranteed benefits applies to a substantial owner with less than 50 percent ownership interest. For a substantial owner with a 50 percent or more ownership interest ("majority owner"), the phase-in occurs over a 10-year period and depends on the number of years the plan

has been in effect. The majority owner's guaranteed benefit is limited so that it cannot be more than the amount phased in over 60 months for other participants. The rules regarding allocation of assets apply to substantial owners, other than majority owners, in the same manner as other participants.

### *Effective Date*

The provision is effective for plan terminations with respect to which notices of intent to terminate are provided, or for which proceedings for termination are instituted by the PBGC, after December 31, 2005.

## H. Acceleration of PBGC Computation of Benefits Attributable to Recoveries from Employers (sec. 408 of the Act and secs. 4022(c), 4044, and 4062(c) of ERISA)

### *Present Law*

#### *In general*

The Pension Benefit Guaranty Corporation ("PBGC") provides insurance protection for participants and beneficiaries under certain defined benefit pension plans by guaranteeing certain basic benefits under the plan in the event the plan is terminated with insufficient assets to pay promised benefits.[529] The guaranteed benefits are funded in part by premium payments from employers who sponsor defined benefit plans. In general, the PBGC guarantees all basic benefits which are payable in periodic installments for the life (or lives) of the participant and his or her beneficiaries and are non-forfeitable at the time of plan termination. For plans terminating in 2006, the maximum guaranteed benefit for an individual retiring at age 65 and receiving a straight life annuity is $3971.59 per month, or $47,659.08 per year.

The PBGC pays plan benefits, subject to the guarantee limits, when it becomes trustee of a terminated plan. The PBGC also pays amounts in addition to the guarantee limits ("additional benefits") if there are sufficient plan assets, including amounts recovered from the employer for unfunded benefit liabilities and contributions owed to the plan. The employer (including members of its controlled group) is statutorily liable for these amounts.

#### *Plan underfunding recoveries*

The PBGC's recoveries on its claims for unfunded benefit liabilities are shared between the PBGC and plan participants. The amounts recovered are allocated partly to the PBGC to help cover its losses for paying unfunded guaranteed benefits and partly to participants to help cover the loss of benefits that are above the PBGC's guarantees and are not funded. In determining the portion of the recovered amounts that will be allocated to participants, present law specifies the use of a recovery ratio based on plan terminations during a specified period, rather than the actual amount recovered for each specific plan. The recovery ratio that applies to

[529] The PBGC termination insurance program does not cover plans of professional service employers that have fewer than 25 participants.

a plan includes the PBGC's actual recovery experience for plan terminations in the five-Federal fiscal year period immediately preceding the Federal fiscal year in which falls the notice of intent to terminate for the particular plan.

The recovery ratio is used for all but very large plans taken over by the PBGC. For a very large plan (i.e., a plan for which participants' benefit losses exceed $20 million) actual recovery amounts with respect to the specific plan are used to determine the portion of the amounts recovered that will be allocated to participants.

***Recoveries for due and unpaid employer contributions***

Amounts recovered from an employer for contributions owed to the plan are treated as plan assets and are allocated to plan benefits in the same manner as other assets in the plan's trust on the plan termination date. The amounts recovered are determined on a plan-specific basis rather than based on an historical average recovery ratio.

### *Explanation of Provision*

The provision changes the five-year period used to determine the recovery ratio for unfunded benefit liabilities so that the period begins two years earlier. Thus, under the provision, the recovery ratio that applies to a plan includes the PBGC's actual recovery experience for plan terminations in the five-Federal fiscal year period ending with the third fiscal year preceding the fiscal year in which falls the notice of intent to terminate for the particular plan.

In addition, the provision creates a recovery ratio for determining amounts recovered for contributions owed to the plan, based on the PBGC's recovery experience over the same five-year period.

The provision does not apply to very large plans (i.e., plans for which participants' benefit losses exceed $20 million). As under present law, in the case of a very large plan, actual amounts recovered for unfunded benefit liabilities and for contributions owed to the plan are used to determine the amount available to provide additional benefits to participants.

### *Effective Date*

The provision is effective for any plan termination for which notices of intent to terminate are provided (or, in the case of a termination by the PBGC, a notice of determination that the plan must be terminated is issued) on or after the date that is 30 days after the date of enactment (August 17, 2006).

## I. Treatment of Certain Plans Where There is a Cessation or Change in Membership of a Controlled Group (sec. 409 of the Act and sec. 4041(b) of ERISA)

### *Present Law*

An employer may voluntarily terminate a single-employer plan only in a standard termination or a distress termination. A standard termination is permitted only if plan assets are sufficient to cover benefit liabilities. Benefit liabilities are defined generally as the present value of all benefits due under the plan (this amount

is referred to as "termination liability"). This present value is determined using interest and mortality assumptions prescribed by the PBGC.

### *Explanation of Provision*

Under the provision, if: (1) there is a transaction or series of transactions which result in a person ceasing to be a member of a controlled group; and (2) such person, immediately before the transaction or series of transactions maintained a single-employer defined benefit plan which is fully funded, then the interest rate used in determining whether the plan is sufficient for benefit liabilities or to otherwise assess plan liabilities for purposes of section 4041(b) or section 4042(a)(4) shall not be less than the interest rate used in determining whether the plan is fully funded.

The provision does not apply to any transaction or series of transactions unless (1) any employer maintaining the plan immediately before or after such transactions or series of transactions (a) has an outstanding senior unsecured debt instrument which is rated investment grade by each of the nationally recognized statistical rating organizations for corporate bonds that has issued a credit rating for such instrument, or (b) if no such debt instrument of such employer has been rated by such an organization but one or more of such organizations has made an issuer credit rating for such employer, all such organizations which have so rated the employer have rated such employer investment grade and (2) the employer maintaining the plan after the transaction or series of transaction employs at least 20 percent of the employees located within United States who were employed by such employer immediately before the transaction or series of transactions.

The provision does not apply in the case of determinations of liabilities by the PBGC or a court if the plan is terminated after the close of the two-year period beginning on the date of the transaction (or first transaction in a series of transactions).

For purposes of the provision, a plan is considered fully funded with respect to a transaction or series of transactions if (1) in the case of a transaction or series of transactions which occur in a plan year beginning before January 1, 2008, the funded current liability percentage for the plan year (determined under the minimum funding rules) is at least 100 percent, or (2) in the case of a transaction or series of transactions which occur on or after January 1, 2008, the funding target attainment percentage (as determined under the minimum funding rules) as of the valuation date for the plan year is at least 100 percent.

### *Effective Date*

The provision applies to transactions or series of transactions occurring on or after the date of enactment (August 17, 2006).

## J. Missing Participants (sec. 410 of the Act and sec. 4050 of ERISA)

### *Present Law*

In the case of a defined benefit pension plan that is subject to the plan termination insurance program under Title IV of the Employee Retirement Income Security Act of 1974 (”ERISA”), is maintained by a single employer, and terminates under a standard termination, the plan administrator generally must purchase annuity contracts from a private insurer to provide the benefits to which participants are entitled and distribute the annuity contracts to the participants.

If the plan administrator of a terminating single employer plan cannot locate a participant after a diligent search (a “missing participant”), the plan administrator may satisfy the distribution requirement only by purchasing an annuity from an insurer or transferring the participant’s designated benefit to the Pension Benefit Guaranty Corporation (“PBGC”), which holds the benefit of the missing participant as trustee until the PBGC locates the missing participant and distributes the benefit.[530]

The PBGC missing participant program is not available to multiemployer plans or defined contribution plans and other plans not covered by Title IV of ERISA.

### *Explanation of Provision*

Under the provision, the PBGC is directed to prescribe rules for terminating multiemployer plans similar to the present-law missing participant rules applicable to terminating single-employer plans that are subject to Title IV of ERISA.

In addition, under the provision, plan administrators of certain types of plans not subject to the PBGC termination insurance program under present law are permitted, but not required, to elect to transfer missing participants’ benefits to the PBGC upon plan termination. Specifically, the provision extends the missing participants program (in accordance with regulations) to defined contribution plans, defined benefit pension plans that have no more than 25 active participants and are maintained by professional service employers, and the portion of defined benefit pension plans that provide benefits based upon the separate accounts of participants and therefore are treated as defined contribution plans under ERISA.

### *Effective Date*

The provision is effective for distributions made after final regulations implementing the provision are prescribed.

[530] Secs. 4041(b)(3)(A) and 4050 of ERISA.

## K. Director of the PBGC (sec. 411 of the Act and secs. 4002 and 4003 of ERISA)

### *Present Law*

The PBGC is a corporation within the Department of Labor. In carrying out its functions, the PBGC is administered by the chairman of the board of directors in accordance with the policies established by the board. The board of directors consists of the Secretaries of Labor, Treasury and Commerce.[531] The Secretary of Labor is the chairman of the board. The executive director of the PBGC is selected by the chairman of the board.

The PBGC is authorized to make such investigations as it deems necessary to enforce any provisions of title IV of ERISA or any rule or regulation thereunder. For the purpose of any such investigation (or any other proceeding under title IV or ERISA), any member of the board of directors or any officer designated by the chairman of the board may administer oaths, subpoena witnesses and take other actions as provided by ERISA as the corporation deems relevant or material to the inquiry.[532]

### *Explanation of Provision*

The provision provides that, in carrying out its functions, the PBGC will be administered by a Director, who is appointed by the President by and with the advice and consent of the Senate. The Director is to act in accordance with the policies established by the PBGC board. The Senate Committees on Finance and on Health, Education, Labor, and Pensions are given joint jurisdiction over the nomination of a person nominated by the President to be Director of the PBGC. If one of such Committees votes to order reported such a nomination, the other such Committee is to report on the nomination within 30 calendar days, or it is automatically discharged.[533]

The Director, and any officer designated by the Director, is given the authority with respect to investigations that is provided under present law to members of the PBGC board and officers designated by the chairman of the board.

The Director is to be compensated at the rate of compensation provided under Level III of the Executive Schedule.[534] Effective January 1, 2006, such annual rate of pay is $152,000.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006). The term of the individual serving as Executive Director of the PBGC on the date of enactment expires on the date of enactment. Such individual, or any other individual, may serve as in-

---

[531] ERISA sec. 4002.

[532] ERISA sec. 4003.

[533] The provision relating to the Senate committees is treated as an exercise of rulemaking power of the Senate and is deemed a part of the rules of the Senate. It is applicable only with respect to the procedure to be followed in the case of a nomination of the Director of the PBGC and it supersedes other Senate rules only to the extent that it is inconsistent with such rules. The provision does not change the constitutional right of the Senate to change its rules (so far as relating to the procedure of the Senate) at any time, in the same manner and to the same extent as in the case of any other rule of the Senate.

[534] 5 U.S.C. sec. 5314.

terim Director of the PBGC until an individual is appointed as Director in accordance with the provision.

## L. Inclusion of Information in the PBGC Annual Report (sec. 412 of the Act and sec. 4008 of ERISA)

### *Present Law*

As soon as practicable after the close of each fiscal year, the PBGC is required to transmit to the President and Congress a report relative to the conduct of its business for the year. The report must include (1) financial statements setting forth its finances and the result of its operations and (2) an actuarial evaluation of the expected operations and status of the four revolving funds used by the PBGC in carrying out its operations.

### *Explanation of Provision*

Under the provision, additional information is required to be provided in the PBGC's annual report. The report must include (1) a summary of the Pension Insurance Modeling System microsimulation model, including the specific simulation parameters, specific initial values, temporal parameters, and policy parameters used to calculate the PBGC's financial statements; (2) a comparison of (a) the average return on investments earned with respect to assets invested by the PBGC for the year to which the report relates and (b) an amount equal to 60 percent of the average return on investment for the year in the Standard & Poor's 500 Index, plus 40 percent of the average return on investment for such year in the Lehman Aggregate Bond Index (or in a similar fixed income index), and (3) a statement regarding the deficit or surplus for the year that the PBGC would have had if it had earned the return described in (2) with respect to its invested assets.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## TITLE V—DISCLOSURE

### A. Defined Benefit Plan Funding Notice (sec. 501 of the Act and secs. 101(f) and 4011 of ERISA)

#### *Present Law*

Defined benefit pension plans are generally required to meet certain minimum funding requirements. These requirements are designed to help ensure that such plans are adequately funded. In addition, the Pension Benefit Guaranty Corporation ("PBGC") guarantees benefits under defined benefit pension plans, subject to limits.

Certain notices must be provided to participants in a single-employer defined benefit pension plan relating to the funding status of the plan. For example, ERISA requires an employer of a single-employer defined benefit plan to notify plan participants if the employer fails to make required contributions (unless a request for a funding waiver is pending).[535] In addition, in the case of an underfunded single-employer plan for which PBGC variable rate premiums are required, the plan administrator generally must notify plan participants of the plan's funding status and the limits on the PBGC benefit guarantee if the plan terminates while underfunded.[536]

Effective for plan years beginning after December 31, 2004, the plan administrator of a multiemployer defined benefit pension plan must provide an annual funding notice to: (1) each participant and beneficiary; (2) each labor organization representing such participants or beneficiaries; (3) each employer that has an obligation to contribute under the plan; and (4) the PBGC.

Such a notice must include: (1) identifying information, including the name of the plan, the address and phone number of the plan administrator and the plan's principal administrative officer, each plan sponsor's employer identification number, and the plan identification number; (2) a statement as to whether the plan's funded current liability percentage for the plan year to which the notice relates is at least 100 percent (and if not, a statement of the percentage); (3) a statement of the value of the plan's assets, the amount of benefit payments, and the ratio of the assets to the payments for the plan year to which the notice relates; (4) a summary of the rules governing insolvent multiemployer plans, including the limitations on benefit payments and any potential benefit reductions and suspensions (and the potential effects of such limitations, reductions, and suspensions on the plan); (5) a general description of the benefits under the plan that are eligible to be guaranteed by the PBGC and the limitations of the guarantee and circumstances

[535] ERISA sec. 101(d).
[536] ERISA sec. 4011.

in which such limitations apply; and (6) any additional information the plan administrator elects to include to the extent it is not inconsistent with regulations prescribed by the Secretary of Labor.

The annual funding notice must be provided no later than two months after the deadline (including extensions) for filing the plan's annual report for the plan year to which the notice relates (i.e., nine months after the end of the plan year unless the due date for the annual report is extended). The funding notice must be provided in a form and manner prescribed in regulations by the Secretary of Labor. Additionally, it must be written so as to be understood by the average plan participant and may be provided in written, electronic, or some other appropriate form to the extent that it is reasonably accessible to persons to whom the notice is required to be provided.

A plan administrator that fails to provide the required notice to a participant or beneficiary may be liable to the participant or beneficiary in the amount of up to $100 a day from the time of the failure and for such other relief as a court may deem proper.

### *Explanation of Provision*

The provision expands the annual funding notice requirement that applies under present law to multiemployer plans, so that it applies also to single-employer plans and, in the case of a single-employer plan, includes a summary of the PBGC rules governing plan termination. The provision also changes the information that must be provided in the notice and accelerates the time when the notice must be provided.

In addition to the information required under present law, an annual funding notice with respect to either a single-employer or multiemployer plan must include the following additional information, as of the end of the plan year to which the notice relates: (1) a statement of the number of participants who are retired or separated from service and receiving benefits, retired or separated participants who are entitled to future benefits, and active participants; (2) a statement setting forth the funding policy of the plan and the asset allocation of investments under the plan (expressed as percentages of total assets); (3) an explanation containing specific information of any plan amendment, scheduled benefit increase or reduction, or other known event taking effect in the current plan year and having a material effect on plan liabilities or assets for the year (as defined in regulations by the Secretary); and (4) a statement that a person may obtain a copy of the plan's annual report upon request, through the Department of Labor Internet website, or through an Intranet website maintained by the applicable plan sponsor.

In the case of a single-employer plan, the notice must provide: (1) a statement as to whether the plan's funding target attainment percentage (as defined under the minimum funding rules for single-employer plans) for the plan year to which the notice relates and the two preceding plan years, is at least 100 percent (and, if not, the actual percentages); (2) a statement of (a) the total assets (separately stating any funding standard carryover or prefunding balance) and the plan's liabilities for the plan year and the two preceding years, determined in the same manner as under the funding

rules, and (b) the value of the plan's assets and liabilities as of the last day of the plan year to which the notice relates, determined using fair market value and the interest rate used in determining variable rate premiums; and (3) if applicable, a statement that each contributing sponsor, and each member of the sponsor's controlled group, was required to provide the information under section 4010 for the plan year to which the notice relates.

In the case of a multiemployer plan, the notice must provide: (1) a statement as to whether the plan's funded percentage (as defined under the minimum funding rules for multiemployer plans) for the plan year to which the notice relates and the two preceding plan years, is at least 100 percent (and, if not, the actual percentages); (2) a statement of the value of the plan's assets and liabilities for the plan year to which the notice relates and the two preceding plan years; (3) whether the plan was in endangered or critical status and, if so, a summary of the plan's funding improvement or rehabilitation plan and a statement describing how a person can obtain a copy of the plan's funding improvement or rehabilitation plan and the actuarial or financial data that demonstrate any action taken by the plan toward fiscal improvement; and (4) a statement that the plan administrator will provide, on written request, a copy of the plan's annual report to any labor organization representing participants and beneficiaries and any employer that has an obligation to contribute to the plan.

The annual funding notice must be provided within 120 days after the end of the plan year to which it relates. In the case of a plan covering not more than 100 employees for the preceding year, the annual funding notice must be provided upon filing of the annual report with respect to the plan (i.e., within seven months after the end of the plan year unless the due date for the annual report is extended).

The Secretary of Labor is required to publish a model notice not later than one year after the date of enactment (August 17, 2006). In addition, the Secretary of Labor is given the authority to promulgate any interim final rules as appropriate to carry out the requirement that a model notice be published.

Under the provision, the annual funding notice includes the information provided in the notice required under present law in the case of a single-employer plan that is subject to PBGC variable rate premiums. Accordingly, that present-law notice requirement is repealed under the provision.

### *Effective Date*

The provision is effective for plan years beginning after December 31, 2007, except that the repeal of the notice required under present law in the case of a single-employer plan that is subject to PBGC variable rate premiums is effective for plan years beginning after December 31, 2006. Under a transition rule, any requirement to report a plan's funding target attainment percentage or funded percentage for a plan year beginning before January 1, 2008, is met if (1) in the case of a plan year beginning in 2006, the plan's funded current liability percentage is reported, and (2) in the case of a plan year beginning in 2007, the funding target attainment percentage or funded percentage as determined using such methods of

estimation as the Secretary of the Treasury may provide is reported.

## B. Access to Multiemployer Pension Plan Information (sec. 502 of the Act, secs. 101, 204(h), and 502(c) of ERISA, and sec. 4980F of the Code)

### *Present Law*

#### *Annual report*

The plan administrator of a pension plan generally must file an annual return with the Secretary of the Treasury, an annual report with the Secretary of Labor, and certain information with the Pension Benefit Guaranty Corporation ("PBGC"). Form 5500, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 with the Department of Labor.

In the case of a defined benefit pension plan, the annual report must include an actuarial statement. The actuarial statement must include, for example, information as to the value of plan assets, the plan's accrued and current liabilities, the plan's actuarial cost method and actuarial assumptions, and plan contributions. The report must be signed by an actuary enrolled to practice before the IRS, Department of Labor and the PBGC.

The Form 5500 is due by the last day of the seventh month following the close of the plan year. The due date generally may be extended up to two and one-half months. Copies of filed Form 5500s are available for public examination at the U.S. Department of Labor.

#### *Notice of significant reduction in benefit accruals*

If an amendment to a defined benefit pension plan provides for a significant reduction in the rate of future benefit accrual, the plan administrator must furnish a written notice concerning the amendment. Notice may also be required if a plan amendment eliminates or reduces an early retirement benefit or retirement-type subsidy. The plan administrator is required to provide the notice to any participant or alternate payee whose rate of future benefit accrual may reasonably be expected to be significantly reduced by the plan amendment (and to any employee organization representing affected participants). The notice must be written in a manner calculated to be understood by the average plan participant and must provide sufficient information to allow recipients to understand the effect of the amendment. The plan administrator is generally required to provide the notice at least 45 days before the effective date of the plan amendment.

### *Explanation of Provision*

Under the provision, a plan administrator of a multiemployer plan must, within 30 days of a written request, provide a plan participant or beneficiary, employee organization or employer that has an obligation to contribute to the plan with a copy of: (1) any periodic actuarial report (including any sensitivity testing) for any plan

year that has been in the plan's possession for at least 30 days; (2) a copy of any quarterly, semi-annual, or annual financial report prepared for the plan by any plan investment manager or advisor or other person who is a plan fiduciary that has been in the plan's possession for at least 30 days; and (3) a copy of any application for an amortization extension filed with the Secretary of the Treasury. Any actuarial report, financial report, or amortization extension application provided to a participant, beneficiary, or employer must not include any individually identifiable information regarding any participant, beneficiary, employee, fiduciary, or contributing employer, or reveal any proprietary information regarding the plan, any contributing employer, or any entity providing services to the plan. Regulations relating to the requirement to provide these documents on request must be issued within one year after the date of enactment (August 17, 2006).

In addition, the plan sponsor or administrator of a multiemployer plan must provide to any employer having an obligation to contribute to the plan, within 180 days of a written request, notice of: (1) the estimated amount that would be the employer's withdrawal liability with respect to the plan if the employer withdrew from the plan on the last day of the year preceding the date of the request; and (2) an explanation of how the estimated liability amount was determined, including the actuarial assumptions and methods used to determine the value of plan liabilities and assets, the data regarding employer contributions, unfunded vested benefits, annual changes in the plan's unfunded vested benefits, and the application of any relevant limitations on the estimated withdrawal liability. Regulations may permit a longer time than 180 days as may be necessary in the case of a plan that determines withdrawal liability using certain methods.

A person is not entitled to receive more than one copy of any actuarial or financial report or amortization extension application or more than one notice of withdrawal liability during any 12-month period. The plan administrator or sponsor may make a reasonable charge to cover copying, mailing, and other costs of furnishing copies or notices, subject to a maximum amount that may be prescribed by regulations. Any information or notice required to be provided under the provision may be provided in written, electronic, or other appropriate form to the extent such form is reasonably available to the persons to whom the information is required to be provided.

In the case of a failure to comply with these requirements, the Secretary of Labor may assess a civil penalty of up to $1,000 per day for each failure to provide a notice.

Under the provision, notice of an amendment that provides for a significant reduction in the rate of future benefit accrual must be provided also to each employer that has an obligation to contribute to the plan.

### *Effective Date*

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

## C. Additional Annual Reporting Requirements and Electronic Display of Annual Report Information (secs. 503–504 of the Act and secs. 103 and 104 of ERISA)

### *Present Law*

#### *Annual report*

The plan administrator of a pension plan generally must file an annual return with the Secretary of the Treasury, an annual report with the Secretary of Labor, and certain information with the Pension Benefit Guaranty Corporation ("PBGC"). Form 5500, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 with the Department of Labor.

In the case of a defined benefit pension plan, the annual report must include an actuarial statement. The actuarial statement must include, for example, information as to the value of plan assets, the plan's accrued and current liabilities, the plan's actuarial cost method and actuarial assumptions, and plan contributions. The report must be signed by an actuary enrolled to practice before the IRS, Department of Labor and the PBGC.

The Form 5500 is due by the last day of the seventh month following the close of the plan year. The due date generally may be extended up to two and one-half months. Copies of filed Form 5500s are available for public examination at the U.S. Department of Labor.

#### *Summary annual report*

A participant must be provided with a copy of the full annual report on written request. In addition, the plan administrator must automatically provide participants with a summary of the annual report within two months after the due date of the annual report (i.e., by the end of the ninth month after the end of the plan year unless an extension applies). The summary annual report must include a statement whether contributions were made to keep the plan funded in accordance with minimum funding requirements, or whether contributions were not made and the amount of the deficit. The current value of plan assets is also required to be disclosed. If an extension applies for the Form 5500, the summary annual report must be provided within two months after the extended due date. A plan administrator who fails to provide a summary annual report to a participant within 30 days of the participant making a request for the report may be liable to the participant for a civil penalty of up to $100 a day from the date of the failure.

### *Explanation of Provision*

#### *Annual report*

The provision requires additional information to be provided in the annual report filed with respect to a defined benefit pension plan. In a case in which the liabilities under the plan as of the end of a plan year consist (in whole or in part) of liabilities under two or more other pension plans as of immediately before the plan year,

the annual report must include the plan's funded percentage as of the last day of the plan year and the funded percentage of each of such other plans. Funded percentage is defined as: (1) in the case of a single-employer plan, the plan's funded target attainment percentage (as defined under the minimum funding rules for single-employer plans); and (2) in the case of a multiemployer plan, the plan's funded percentage (as defined under the minimum funding rules for multiemployer plans).

An annual report filed with respect to a multiemployer plan must include, as of the end of the plan year, the following additional information: (1) the number of employers obligated to contribute to the plan; (2) a list of the employers that contributed more than five percent of the total contributions to the plan during the plan year; (3) the number of participants on whose behalf no contributions were made by an employer as an employer of the participant for the plan year and two preceding years; (4) the ratios of the number of participants under the plan on whose behalf no employer had an obligation to make an employer contribution during the plan year, to the number of participants under the plan on whose behalf no employer had an obligation to make an employer contribution during each of the two preceding plan years; (5) whether the plan received an amortization extension for the plan year and, if so, the amount by which it changed the minimum required contribution for the year, what minimum contribution would have been required without the extension, and the period of the extension; (6) whether the plan used the shortfall funding method and, if so, the amount by which it changed the minimum required contribution for the year, what minimum contribution would have been required without the use of this method, and the period for which the method is used; (7) whether the plan was in critical or endangered status for the plan year, and if so, a summary of any funding improvement or rehabilitation plan (or modification thereto) adopted during the plan year, and the funded percentage of the plan; (8) the number of employers that withdrew from the plan during the preceding plan year and the aggregate amount of withdrawal liability assessed, or estimated to be assessed, against the withdrawn employers; (9) if the plan that has merged with another plan or if assets and liabilities have been transferred to the plan, the actuarial valuation of the assets and liabilities of each affected plan during the year preceding the effective date of the merger or transfer, based upon the most recent data available as of the day before the first day of the plan year, or other valuation method performed under standards and procedures as prescribed by regulation.

The Secretary of Labor is required, not later than one year after the date of enactment (August 17, 2006), to publish guidance to assist multiemployer plans to identify and enumerate plan participants for whom there is no employer with an obligation to make an employer contribution under the plan and report such information in the annual report. The Secretary may provide rules as needed to apply this requirement with respect to contributions made on a basis other than hours worked, such as on the basis of units of production.

The actuarial statement filed with the annual return must include a statement explaining the actuarial assumptions and methods used in projecting future retirements and asset distributions under the plan.

***Electronic display of annual report***

Identification and basic plan information and actuarial information included in the annual report must be filed with the Secretary of Labor in an electronic format that accommodates display on the Internet (in accordance with regulations). The Secretary of Labor is to provide for the display of such information, within 90 days after the filing of the annual report, on a website maintained by the Secretary of Labor on the Internet and other appropriate media. Such information is also required to be displayed on any Intranet website maintained by the plan sponsor (or by the plan administrator on behalf of the plan sponsor) in accordance with regulations.

***Summary annual report***

Under the provision, the requirement to provide a summary annual report to participants applies does not apply to defined benefit pension plans.[537]

***Multiemployer plan summary report***

The provision requires the plan administrator of a multiemployer plan to provide a report containing certain summary plan information to each employee organization and each employer with an obligation to contribute to the plan within 30 days after the due date of the plan's annual report. The report must contain: (1) a description of the contribution schedules and benefit formulas under the plan, and any modification to such schedules and formulas, during such plan year; (2) the number of employers obligated to contribute to the plan; (3) a list of the employers that contributed more than 5 percent of the total contributions to the plan during such plan year; (4) the number of participants under the plan on whose behalf no employer contributions have been made to the plan for such plan year and for each of the two preceding plan years; (5) whether the plan was in critical or endangered status for the plan year and, if so, a list of the actions taken by the plan to improve its funding status and a statement describing how to obtain a copy of the plan's funding improvement or rehabilitation plan, as applicable, and the actuarial and financial data that demonstrate any action taken by the plan toward fiscal improvement; (6) the number of employers that withdrew from the plan during the preceding plan year and the aggregate amount of withdrawal liability assessed, or estimated to be assessed, against such withdrawn employers, as reported on the annual report for the plan year; (7) if the plan has merged with another plan or if assets and liabilities have been transferred to the plan, the actuarial valuation of the assets and liabilities of each affected plan during the year preceding the effective date of the merger or transfer, based upon the most recent

[537] As discussed in Part A above, detailed information about a defined benefit pension plan must be provided to participants in an annual funding notice.

data available as of the day before the first day of the plan year, or other valuation method performed under standards and procedures as prescribed by regulation; (8) a description as to whether the plan sought or received an amortization extension or used the shortfall funding method for the plan year; and (9) notification of the right to obtain upon written request a copy of the annual report filed with respect to the plan, the summary plan description, and the summary of any material modification of the plan, subject to a limitation of one copy of any such document in any 12-month period and any reasonable charge to cover copying, mailing, and other costs of furnishing the document. Nothing in this report requirement waives any other ERISA provision requiring plan administrators to provide, upon request, information to employers that have an obligation to contribute under the plan.

### *Effective Date*

The provisions are effective for plan years beginning after December 31, 2007.

## D. Section 4010 Filings with the PBGC (sec. 505 of the Act and sec. 4010 of ERISA)

### *Present Law*

Present law provides that, in certain circumstances, the contributing sponsor of a single-employer plan defined benefit pension plan covered by the PBGC (and members of the contributing sponsor's controlled group) must provide certain information to the PBGC (referred to as "section 4010 reporting"). This information includes financial information with respect to the contributing sponsor (and controlled group members) and actuarial information with respect to single-employer plans maintained by the sponsor (and controlled group members).[538] Section 4010 reporting is required if: (1) the aggregate unfunded vested benefits (determined using the interest rate used in determining variable-rate premiums) as of the end of the preceding plan year under all plans maintained by members of the controlled group exceed $50 million (disregarding plans with no unfunded vested benefits); (2) the conditions for imposition of a lien (i.e., required contributions totaling more than $1 million have not been made) have occurred with respect to an underfunded plan maintained by a member of the controlled group; or (3) minimum funding waivers in excess of $1 million have been granted with respect to a plan maintained by any member of the controlled group and any portion of the waived amount is still outstanding. Information provided to the PBGC in accordance with these requirements is not available to the public.

The PBGC may assess a penalty for a failure to provide the required information in the amount of up to $1,000 a day for each day the failure continues.[539]

[538] ERISA sec. 4010.
[539] ERISA sec. 4071.

### *Explanation of Provision*

Under the provision, the requirement of section 4010 reporting applicable under present law if aggregate unfunded vested benefits exceed $50 million is replaced with a requirement of section 4010 reporting if: (1) the funding target attainment percentage at the end of the preceding plan year of a plan maintained by a contributing sponsor or any member of its controlled group is less than 80 percent. It is intended that the PBGC may waive the requirement in appropriate circumstances, such as in the case of small plans.

The provision also requires the information provided to the PBGC to include the following: (1) the amount of benefit liabilities under the plan determined using the assumptions used by the PBGC in determining liabilities; (2) the funding target of the plan determined as if the plan has been in at-risk status for at least 5 plan years; and (3) the funding target attainment percentage of the plan.

A plan's funding target, a plan's funding target attainment percentage, and at-risk status are determined under the provision relating to funding rules applicable to single-employer plans under the Act. Thus, a plan's funding target for a plan year is the present value of the benefits earned or accrued under the plan as of the beginning of the plan year. A plan's "funding target attainment percentage" means the ratio, expressed as a percentage, that the value of the plan's assets (reduced by any funding standard carryover balance and prefunding balance) bears to the plan's funding target for the year (determined without regard to the special assumptions that apply to at-risk plans). A plan is in at-risk status for a plan year if the plan's funding target attainment percentage for the preceding year was less than (1) 80 percent, determined without regard to the special at-risk assumptions, and (2) 70 percent, determined using the special at-risk assumptions.

The provision requires the PBGC to provide the Senate Committees on Health, Education, Labor, and Pensions and Finance and the House Committees on Education and the Workforce and Ways and Means with a summary report in the aggregate of the information submitted to the PBGC under section 4010.

### *Effective Date*

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

## E. Disclosure of Plan Termination Information to Plan Participants (sec. 506 of the Act and secs. 4041 and 4042 of ERISA)

### *Present Law*

In the case of a single-employer defined benefit pension plan covered under the PBGC insurance program, the plan sponsor may voluntarily terminate the plan in a standard termination or a dis-

tress termination.[540] A standard termination is permitted only if plan assets are sufficient to cover benefit liabilities.

If assets in a defined benefit plan are not sufficient to cover benefit liabilities, the plan sponsor may not terminate the plan unless the plan sponsor (and members of the plan sponsor's controlled group) meets one of four criteria of financial distress. The four criteria for a distress termination are: (1) the plan sponsor, and every member of the controlled group of which the sponsor is a member, is being liquidated in bankruptcy or any similar Federal law or other similar State insolvency proceedings; (2) the plan sponsor and every member of the sponsor's controlled group is being reorganized in bankruptcy or similar State proceeding; (3) the PBGC determines that termination is necessary to allow the plan sponsor to pay its debts when due; or (4) the PBGC determines that termination is necessary to avoid unreasonably burdensome pension costs caused solely by a decline in the plan sponsor's work force.

In order for a plan sponsor to terminate a plan, the plan administrator must provide each affected party with advance written notice of the intent to terminate at least 60 days before the proposed termination date. Additional information must be included as required by the PBGC. For this purpose, an affected party is: (1) a plan participant; (2) a beneficiary of a deceased participant or an alternate payee under a qualified domestic relations order; (3) any employee organization representing plan participants; and (4) the PBGC (except in the case of a standard termination). In the case of a proposed distress termination, as soon as practicable after providing notice, the plan administrator must provide the PBGC with certain information, including information necessary for the PBGC to determine whether any of the criteria for a distress termination is met.

The PBGC may institute proceedings to terminate a single-employer plan if it determines that the plan in question: (1) has not met the minimum funding standards; (2) will be unable to pay benefits when due; (3) has a substantial owner who has received a distribution greater than $10,000 (other than by reason of death) while the plan has unfunded vested benefits; or (4) may reasonably be expected to increase the PBGC's long-run loss with respect to the plan unreasonably if the plan is not terminated. The PBGC must institute proceedings to terminate a plan if the plan is unable to pay benefits that are currently due.

If the PBGC determines that the requirements for an involuntary plan termination are met, it must provide notice to the plan.

### *Explanation of Provision*

The provision revises the rules applicable in the case of a distress termination to require a plan administrator to provide an affected party with any information provided to the PBGC in connection with the proposed plan termination. The plan administrator must provide the information not later than 15 days after: (1) the receipt of a request for the information from the affected party; or

[540] The PBGC may not proceed with a voluntary termination if the termination would violate an existing collective bargaining agreement.

(2) the provision of new information to the PBGC relating to a previous request.

The provision also requires the plan sponsor or plan administrator of a plan that has received notice from the PBGC of a determination that the plan should be involuntarily terminated to provide an affected party with any information provided to the PBGC in connection with the plan termination. In addition, the PBGC is required to provide a copy of the administrative record, including the trusteeship decision record in connection with a plan termination. The plan sponsor, plan administrator, or PBGC must provide the required information not later than 15 days after: (1) the receipt of a request for the information from the affected party; or (2) in the case of information provided to the PBGC, the provision of new information to the PBGC relating to a previous request.

The PBGC may prescribe the form and manner in which information is to be provided, which is to include delivery in written, electronic, or other appropriate form to the extent such form is reasonably accessible to individuals to whom the information is required to be provided. A plan administrator or plan sponsor may charge a reasonable fee for any information provided under this subparagraph in other than electronic form.

A plan administrator or plan sponsor may not provide the relevant information in a form that includes any information that may directly or indirectly be associated with, or otherwise identify, an individual participant or beneficiary. In addition, a court may limit disclosure of confidential information (as described under the Freedom of Information Act) to any authorized representative of the participants or beneficiaries that agrees to ensure the confidentiality of such information. For this purpose, an authorized representative means any employee organization representing participants in the pension plan.

### *Effective Date*

The provision generally applies with respect to any plan termination, with respect to which the notice of intent to terminate, or notice that the PBGC has determined that the requirements for an involuntary plan termination are met, occurs after the date of enactment (August 17, 2006). Under a transition rule, if notice under the provision would otherwise be required before the 90th day after the date of enactment, such notice is not required to be provided until the 90th day.

## F. Notice of Freedom to Divest Employer Securities (sec. 507 of the Act and new sec. 101(m) and sec. 502(c) of ERISA)

### *Present Law*

Under ERISA, a plan administrator is required to furnish participants with certain notices and information about the plan. This information includes, for example, a summary plan description that includes certain information, including administrative information about the plan, the plan's requirements as to eligibility for participation and benefits, the plan's vesting provisions, and the procedures for claiming benefits under the plan. Under ERISA, if a plan

administrator fails or refuses to furnish to a participant information required to be provided to the participant within 30 days of the participant's written request, the participant generally may bring a civil action to recover from the plan administrator $100 a day, within the court's discretion, or other relief that the court deems proper.

### *Explanation of Provision*

The provision requires a new notice in connection with the right of an applicable individual to divest his or her account under an applicable defined contribution plan of employer securities, as required under the provision of the Act relating to diversification rights with respect to amounts invested in employer securities. Not later than 30 days before the first date on which an applicable individual is eligible to exercise such right with respect to any type of contribution, the administrator of the plan must provide the individual with a notice setting forth such right and describing the importance of diversifying the investment of retirement account assets. Under the diversification provision, an applicable individual's right to divest his or her account of employer securities attributable to elective deferrals and employee after-tax contributions and the right to divest his or her account of employer securities attributable to other contributions (i.e., nonelective employer contributions and employer matching contributions) may become exercisable at different times. Thus, to the extent the applicable individual is first eligible to exercise such rights at different times, separate notices are required.

The notice must be written in a manner calculated to be understood by the average plan participant and may be delivered in written, electronic, or other appropriate form to the extent such form is reasonably accessible to the applicable individual. The Secretary of Treasury has regulatory authority over the required notice and is directed to prescribe a model notice to be used for this purpose within 180 days of the date of enactment of the provision (August 17, 2006). It is expected that the Secretary of Treasury will consult with the Secretary of Labor on the description of the importance of diversifying the investment of retirement account assets. In addition, it is intended that the Secretary of Treasury will prescribe rules to enable the notice to be provided at reduced administrative expense, such as allowing the notice to be provided with the summary plan description, with a reminder of these rights within a reasonable period before they become exercisable.

In the case of a failure to provide a required notice of diversification rights, the Secretary of Labor may assess a civil penalty against the plan administrator of up to $100 a day from the date of the failure. For this purpose, each violation with respect to any single applicable individual is treated as a separate violation.

### *Effective Date*

The provision generally applies to plan years beginning after December 31, 2006. Under a transition rule, if notice would otherwise be required to be provided before 90 days after the date of enact-

ment (August 17, 2006), notice is not required until 90 days after the date of enactment.

## G. Periodic Pension Benefit Statements (sec. 508 of the Act and secs. 105(a) and 502(c) of ERISA)

### *Present Law*

ERISA provides that the administrator of a defined contribution or defined benefit pension plan must furnish a benefit statement to any participant or beneficiary who makes a written request for such a statement. The benefit statement must indicate, on the basis of the latest available information: (1) the participant's or beneficiary's total accrued benefit; and (2) the participant's or beneficiary's vested accrued benefit or the earliest date on which the accrued benefit will become vested. A participant or beneficiary is not entitled to receive more than one benefit statement during any 12-month period. If a plan administrator fails or refuses to furnish a benefit statement to a participant or beneficiary within 30 days of a written request, the participant or beneficiary may bring a civil action to recover from the plan administrator $100 a day, within the court's discretion, or other relief that the court deems proper.

### *Explanation of Provision*

#### *In general*

The provision revises the benefit statement requirements under ERISA. The new requirements depend in part on the type of plan and the individual to whom the statement is provided. The benefit statement requirements do not apply to a one-participant retirement plan.[541]

A benefit statement is required to indicate, on the basis of the latest available information: (1) the total benefits accrued; (2) the vested accrued benefit or the earliest date on which the accrued benefit will become vested; and (3) an explanation of any permitted disparity or floor-offset arrangement that may be applied in determining accrued benefits under the plan.[542] With respect to information on vested benefits, the Secretary of Labor is required to provide that the requirements are met if, at least annually, the plan: (1) updates the information on vested benefits that is provided in the benefit statement; or (2) provides in a separate statement information as is necessary to enable participants and beneficiaries to determine their vested benefits.

If a plan administrator fails to provide a required benefit statement to a participant or beneficiary, the participant or beneficiary may bring a civil action to recover from the plan administrator $100 a day, within the court's discretion, or other relief that the court deems proper.

---

[541] A one-participant retirement plan is defined as under the provision of ERISA that requires advance notice of a blackout period to be provided to participants and beneficiaries affected by the blackout period, as discussed in Part H below.

[542] Under the permitted disparity rules, contributions or benefits may be provided at a higher rate with respect to compensation above a specified level and at a lower rate with respect to compensation up to the specified level. In addition, benefits under a defined benefit plan may be offset by a portion of a participant's expected social security benefits. Under a floor-offset arrangement, benefits under a defined benefit pension plan are reduced by benefits under a defined contribution plan.

***Requirements for defined contribution plans***

The administrator of a defined contribution plan is required to provide a benefit statement (1) to a participant or beneficiary who has the right to direct the investment of the assets in his or her account, at least quarterly, (2) to any other participant or other beneficiary who has his or her own account under the plan, at least annually, and (3) to other beneficiaries, upon written request, but limited to one request during any 12-month period.

A benefit statement provided with respect to a defined contribution plan must include the value of each investment to which assets in the individual's account are allocated (determined as of the plan's most recent valuation date), including the value of any assets held in the form of employer securities (without regard to whether the securities were contributed by the employer or acquired at the direction of the individual). A quarterly benefit statement provided to a participant or beneficiary who has the right to direct investments must also provide: (1) an explanation of any limitations or restrictions on any right of the individual to direct an investment; (2) an explanation, written in a manner calculated to be understood by the average plan participant, of the importance, for the long-term retirement security of participants and beneficiaries, of a well-balanced and diversified investment portfolio, including a statement of the risk that holding more than 20 percent of a portfolio in the security of one entity (such as employer securities) may not be adequately diversified; and (3) a notice directing the participant or beneficiary to the Internet website of the Department of Labor for sources of information on individual investing and diversification.

***Requirements for defined benefit plans***

The administrator of a defined benefit plan is required either: (1) to furnish a benefit statement at least once every three years to each participant who has a vested accrued benefit under the plan and who is employed by the employer at the time the benefit statements are furnished to participants; or (2) to furnish at least annually to each such participant notice of the availability of a benefit statement and the manner in which the participant can obtain it. The Secretary of Labor is authorized to provide that years in which no employee or former employee benefits under the plan need not be taken into account in determining the three-year period. It is intended that the annual notice of the availability of a benefit statement may be included with other communications to the participant if done in a manner reasonably designed to attract the attention of the participant.

The administrator of a defined benefit pension plan is also required to furnish a benefit statement to a participant or beneficiary upon written request, limited to one request during any 12-month period.

In the case of a statement provided to a participant with respect to a defined benefit plan (other than at the participant's request), information may be based on reasonable estimates determined under regulations prescribed by the Secretary of Labor in consultation with the Pension Benefit Guaranty Corporation.

### *Form of benefit statement*

A benefit statement must be written in a manner calculated to be understood by the average plan participant. It may be delivered in written, electronic, or other appropriate form to the extent such form is reasonably accessible to the recipient. For example, regulations could permit current benefit statements to be provided on a continuous basis through a secure plan website for a participant or beneficiary who has access to the website.

The Secretary of Labor is directed, within one year after the date of enactment (August 17, 2006), to develop one or more model benefit statements that may be used by plan administrators in complying with the benefit statement requirements. The use of the model statement is optional. It is intended that the model statement include items such as the amount of vested accrued benefits as of the statement date that are payable at normal retirement age under the plan, the amount of accrued benefits that are forfeitable but that may become vested under the terms of the plan, information on how to contact the Social Security Administration to obtain a participant's personal earnings and benefit estimate statement, and other information that may be important to understanding benefits earned under the plan. The Secretary of Labor is also given the authority to promulgate any interim final rules as determined appropriate to carry out the benefit statement requirements.

### *Effective Date*

The provision is generally effective for plan years beginning after December 31, 2006. In the case of a plan maintained pursuant to one or more collective bargaining agreements, the provision is effective for plan years beginning after the earlier of (1) the later of December 31, 2007, or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after the date of enactment), or (2) December 31, 2008.

## H. Notice to Participants or Beneficiaries of Blackout Periods (sec. 509 of the Act and sec. 101(i) of ERISA)

### *Present Law*

### *In general*

The Sarbanes-Oxley Act of 2002[543] amended ERISA to require that the plan administrator of an individual account plan[544] provide advance notice of a blackout period (a "blackout notice") to plan participants and beneficiaries to whom the blackout period applies.[545] Generally, notice must be provided at least 30 days before the beginning of the blackout period. In the case of a blackout period that applies with respect to employer securities, the plan administrator must also provide timely notice of the blackout period

[543] Pub. L. No. 107–204 (2002).

[544] An "individual account plan" is the term generally used under ERISA for a defined contribution plan.

[545] ERISA sec. 101(i), as enacted by section 306(b) of the Sarbanes-Oxley Act of 2002. Under section 306(a), a director or executive officer of a publicly-traded corporation is prohibited from trading in employer stock during blackout periods in certain circumstances. Section 306 is effective 180 days after enactment.

to the employer (or the affiliate of the employer that issued the securities, if applicable).

The blackout notice requirement does not apply to a one-participant retirement plan, which is defined as a plan that (1) on the first day of the plan year, covered only the employer (and the employer's spouse) and the employer owns the entire business (whether or not incorporated) or covers only one or more partners (and their spouses) in a business partnership (including partners in an S or C corporation as defined in section 1361(a) of the Code), (2) meets the minimum coverage requirements without being combined with any other plan that covers employees of the business, (3) does not provide benefits to anyone except the employer (and the employer's spouse) or the partners (and their spouses), (4) does not cover a business that is a member of an affiliated service group, a controlled group of corporations, or a group of corporations under common control, and (5) does not cover a business that leases employees.[546]

### *Definition of blackout period*

A blackout period is any period during which any ability of participants or beneficiaries under the plan, which is otherwise available under the terms of the plan, to direct or diversify assets credited to their accounts, or to obtain loans or distributions from the plan, is temporarily suspended, limited, or restricted if the suspension, limitation, or restriction is for any period of more than three consecutive business days. However, a blackout period does not include a suspension, limitation, or restriction that (1) occurs by reason of the application of securities laws, (2) is a change to the plan providing for a regularly scheduled suspension, limitation, or restriction that is disclosed through a summary of material modifications to the plan or materials describing specific investment options under the plan, or changes thereto, or (3) applies only to one or more individuals, each of whom is a participant, alternate payee, or other beneficiary under a qualified domestic relations order.

### *Timing of notice*

Notice of a blackout period is generally required at least 30 days before the beginning of the period. The 30-day notice requirement does not apply if (1) deferral of the blackout period would violate the fiduciary duty requirements of ERISA and a plan fiduciary so determines in writing, or (2) the inability to provide the 30-day advance notice is due to events that were unforeseeable or circumstances beyond the reasonable control of the plan administrator and a plan fiduciary so determines in writing. In those cases, notice must be provided as soon as reasonably practicable under the circumstances unless notice in advance of the termination of the blackout period is impracticable.

Another exception to the 30-day period applies in the case of a blackout period that applies only to one or more participants or beneficiaries in connection with a merger, acquisition, divestiture, or similar transaction involving the plan or the employer and that

[546] Governmental plans and church plans are exempt from ERISA. Accordingly, the blackout notice requirement does not apply to these plans.

occurs solely in connection with becoming or ceasing to be a participant or beneficiary under the plan by reason of the merger, acquisition, divestiture, or similar transaction. Under the exception, the blackout notice requirement is treated as met if notice is provided to the participants or beneficiaries to whom the blackout period applies as soon as reasonably practicable.

The Secretary of Labor may provide additional exceptions to the notice requirement that the Secretary determines are in the interests of participants and beneficiaries.

### *Form and content of notice*

A blackout notice must be written in a manner calculated to be understood by the average plan participant and must include (1) the reasons for the blackout period, (2) an identification of the investments and other rights affected, (3) the expected beginning date and length of the blackout period, and (4) in the case of a blackout period affecting investments, a statement that the participant or beneficiary should evaluate the appropriateness of current investment decisions in light of the inability to direct or diversify assets during the blackout period, and (5) other matters as required by regulations. If the expected beginning date or length of the blackout period changes after notice has been provided, the plan administrator must provide notice of the change (and specify any material change in other matters related to the blackout) to affected participants and beneficiaries as soon as reasonably practicable.

Notices provided in connection with a blackout period (or changes thereto) must be provided in writing and may be delivered in electronic or other form to the extent that the form is reasonably accessible to the recipient. The Secretary of Labor is required to issue guidance regarding the notice requirement and a model blackout notice.

### *Penalty for failure to provide notice*

In the case of a failure to provide notice of a blackout period, the Secretary of Labor may assess a civil penalty against a plan administrator of up to $100 per day for each failure to provide a blackout notice. For this purpose, each violation with respect to a single participant or beneficiary is treated as a separate violation.

## *Explanation of Provision*

The provision modifies the definition of a one-participant retirement plan to be consistent with Department of Labor regulations under which certain business owners and their spouses are not treated as employees.[547] As modified, a one-participant retirement plan is a plan that: (1) on the first day of the plan year, either covered only one individual (or the individual and his or her spouse) and the individual owned 100 percent of the plan sponsor, whether or not incorporated, or covered only one or more partners (or partners and their spouses) in the plan sponsor; and (2) does not cover a business that leases employees.

[547] 29 C.F.R. sec. 2510.3–3(c) (2006).

***Effective Date***

The provision is effective as if included in section 306 of the Sarbanes-Oxley Act of 2002.

## TITLE VI—INVESTMENT ADVICE, PROHIBITED TRANSACTIONS, AND FIDUCIARY RULES

### A. Prohibited Transaction Exemption for Provision of Investment Advice (sec. 601 of the Act, sec. 408 of ERISA, and sec. 4975 of the Code)

#### *Present Law*

ERISA and the Code prohibit certain transactions between an employer-sponsored retirement plan and a disqualified person (referred to as a "party in interest" under ERISA).[548] Under ERISA, the prohibited transaction rules apply to employer-sponsored retirement plans and welfare benefit plans. Under the Code, the prohibited transaction rules apply to qualified retirement plans and qualified retirement annuities, as well as individual retirement accounts and annuities ("IRAs"), health savings accounts ("HSAs"), Archer MSAs, and Coverdell education savings accounts.[549]

Disqualified persons include a fiduciary of the plan, a person providing services to the plan, and an employer with employees covered by the plan. For this purpose, a fiduciary includes any person who (1) exercises any authority or control respecting management or disposition of the plan's assets, (2) renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has the authority or responsibility to do so, or (3) has any discretionary authority or responsibility in the administration of the plan.

Prohibited transactions include (1) the sale, exchange or leasing of property, (2) the lending of money or other extension of credit, (3) the furnishing of goods, services or facilities, (4) the transfer to, or use by or for the benefit of, the income or assets of the plan, (5) in the case of a fiduciary, any act that deals with the plan's income or assets for the fiduciary's own interest or account, and (6) the receipt by a fiduciary of any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan. However, certain transactions are exempt from prohibited transaction treatment, for example, certain loans to plan participants.

Under ERISA, the Secretary of Labor may assess a civil penalty against a person who engages in a prohibited transaction, other than a transaction with a plan covered by the prohibited transaction rules of the Code. The penalty may not exceed five percent of the amount involved in the transaction for each year or part of a year that the prohibited transaction continues. If the prohibited transaction is not corrected within 90 days after notice from the

[548] ERISA sec. 406; Code sec. 4975.

[549] The prohibited transaction rules under ERISA and the Code generally do not apply to governmental plans or church plans.

Secretary of Labor, the penalty may be up to 100 percent of the amount involved in the transaction. Under the Code, if a prohibited transaction occurs, the disqualified person who participates in the transaction is subject to a two-tier excise tax. The first level tax is 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period and is 100 percent of the amount involved.

## *Explanation of Provision*

### *In general*

The provision adds a new category of prohibited transaction exemption under ERISA and the Code in connection with the provision of investment advice through an "eligible investment advice arrangement" to participants and beneficiaries of a defined contribution plan who direct the investment of their accounts under the plan and to beneficiaries of IRAs.[550] If the requirements under the provision are met, the following are exempt from prohibited transaction treatment: (1) the provision of investment advice; (2) an investment transaction (i.e., a sale, acquisition, or holding of a security or other property) pursuant to the advice; and (3) the direct or indirect receipt of fees or other compensation in connection with the provision of the advice or an investment transaction pursuant to the advice. The prohibited transaction exemptions provided under the provision do not in any manner alter existing individual or class exemptions provided by statute or administrative action.

The provision also directs the Secretary of Labor, in consultation with the Secretary of the Treasury, to determine, based on certain information to be solicited by the Secretary of Labor, whether there is any computer model investment advice program that meets the requirements of the provision and may be used by IRAs. The determination is to be made by December 31, 2007. If the Secretary of Labor determines there is such a program, the exemptions described above apply in connection with the use of the program with respect to IRA beneficiaries. If the Secretary of Labor determines that there is not such a program, such Secretary is directed to grant a class exemption from prohibited transaction treatment (as discussed below) for the provision of investment advice, investment transactions pursuant to such advice, and related fees to beneficiaries of such arrangements.

### *Eligible investment advice arrangements*

#### *In general*

The exemptions provided under the provision apply in connection with the provision of investment advice by a fiduciary adviser under an eligible investment advice arrangement. An eligible investment advice arrangement is an arrangement (1) meeting certain requirements (discussed below) and (2) which either (a) provides that any fees (including any commission or compensation) received by the fiduciary adviser for investment advice or with respect to an investment transaction with respect to plan assets do

[550] The portions of the provision relating to IRAs apply to HSAs, Archer MSAs, and Coverdell education savings accounts. References here to IRAs include such other arrangements as well.

not vary depending on the basis of any investment option selected, or (b) uses a computer model under an investment advice program as described below in connection with the provision of investment advice to a participant or beneficiary. In the case of an eligible investment advice arrangement with respect to a defined contribution plan, the arrangement must be expressly authorized by a plan fiduciary other than (1) the person offering the investment advice program, (2) any person providing investment options under the plan, or (3) any affiliate of (1) or (2).

*Investment advice program using computer model*

If an eligible investment advice arrangement provides investment advice pursuant to a computer model, the model must (1) apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time, (2) use relevant information about the participant or beneficiary, (3) use prescribed objective criteria to provide asset allocation portfolios comprised of investment options under the plan, (4) operate in a manner that is not biased in favor of any investment options offered by the fiduciary adviser or related person, and (5) take into account all the investment options under the plan in specifying how a participant's or beneficiary's account should be invested without inappropriate weighting of any investment option. An eligible investment expert must certify, before the model is used and in accordance with rules prescribed by the Secretary, that the model meets these requirements. The certification must be renewed if there are material changes to the model as determined under regulations. For this purpose, an eligible investment expert is a person who meets requirements prescribed by the Secretary and who does not bear any material affiliation or contractual relationship with any investment adviser or related person.

In addition, if a computer model is used, the only investment advice that may be provided under the arrangement is the advice generated by the computer model, and any investment transaction pursuant the advice must occur solely at the direction of the participant or beneficiary. This requirement does not preclude the participant or beneficiary from requesting other investment advice, but only if the request has not been solicited by any person connected with carrying out the investment advice arrangement.

*Audit requirements*

In the case of an eligible investment advice arrangement with respect to a defined contribution plan, an annual audit of the arrangement for compliance with applicable requirements must be conducted by an independent auditor (i.e., unrelated to the person offering the investment advice arrangement or any person providing investment options under the plan) who has appropriate technical training or experience and proficiency and who so represents in writing. The auditor must issue a report of the audit results to the fiduciary that authorized use of the arrangement. In the case of an eligible investment advice arrangement with respect to IRAs, an audit is required at such times and in such manner as prescribed by the Secretary of Labor.

*Notice requirements*

Before the initial provision of investment advice, the fiduciary adviser must provide written notice (which may be in electronic form) containing various information to the recipient of the advice, including information relating to: (1) the role of any related party in the development of the investment advice program or the selection of investment options under the plan; (2) past performance and rates of return for each investment option offered under the plan; (3) any fees or other compensation to be received by the fiduciary adviser or affiliate; (4) any material affiliation or contractual relationship of the fiduciary adviser or affiliates in the security or other property involved in the investment transaction; (5) the manner and under what circumstances any participant or beneficiary information will be used or disclosed; (6) the types of services provided by the fiduciary adviser in connection with the provision of investment advice; (7) the adviser's status as a fiduciary of the plan in connection with the provision of the advice; and (8) the ability of the recipient of the advice separately to arrange for the provision of advice by another adviser that could have no material affiliation with and receive no fees or other compensation in connection with the security or other property. This information must be maintained in accurate form and must be provided to the recipient of the investment advice, without charge, on an annual basis, on request, or in the case of any material change.

Any notification must be written in a clear and conspicuous manner, calculated to be understood by the average plan participant, and sufficiently accurate and comprehensive so as to reasonably apprise participants and beneficiaries of the required information. The Secretary is directed to issue a model form for the disclosure of fees and other compensation as required by the provision. The fiduciary adviser must maintain for at least six years any records necessary for determining whether the requirements for the prohibited transaction exemption were met. A prohibited transaction will not be considered to have occurred solely because records were lost or destroyed before the end of six years due to circumstances beyond the adviser's control.

*Other requirements*

In order for the exemption to apply, the following additional requirements must be satisfied: (1) the fiduciary adviser must provide disclosures applicable under securities laws; (2) an investment transaction must occur solely at the direction of the recipient of the advice; (3) compensation received by the fiduciary adviser or affiliates in connection with an investment transaction must be reasonable; and (4) the terms of the investment transaction must be at least as favorable to the plan as an arm's length transaction would be.

*Fiduciary adviser*

For purposes of the provision, "fiduciary adviser" is defined as a person who is a fiduciary of the plan by reason of the provision of investment advice to a participant or beneficiary and who is also: (1) registered as an investment adviser under the Investment Advisers Act of 1940 or under State laws; (2) a bank, a similar finan-

cial institution supervised by the United States or a State, or a savings association (as defined under the Federal Deposit Insurance Act), but only if the advice is provided through a trust department that is subject to periodic examination and review by Federal or State banking authorities; (3) an insurance company qualified to do business under State law; (4) registered as a broker or dealer under the Securities Exchange Act of 1934; (5) an affiliate of any of the preceding; or (6) an employee, agent or registered representative of any of the preceding who satisfies the requirements of applicable insurance, banking and securities laws relating to the provision of advice. A person who develops the computer model or markets the investment advice program or computer model is treated as a person who is a plan fiduciary by reason of the provision of investment advice and is treated as a fiduciary adviser, except that the Secretary of Labor may prescribe rules under which only one fiduciary adviser may elect treatment as a plan fiduciary. "Affiliate" means an affiliated person as defined under section 2(a)(3) of the Investment Company Act of 1940. "Registered representative" means a person described in section 3(a)(18) of the Securities Exchange Act of 1934 or a person described in section 202(a)(17) of the Investment Advisers Act of 1940.

*Fiduciary rules*

Subject to certain requirements, an employer or other person who is a plan fiduciary, other than a fiduciary adviser, is not treated as failing to meet the fiduciary requirements of ERISA, solely by reason of the provision of investment advice as permitted under the provision or of contracting for or otherwise arranging for the provision of the advice. This rule applies if: (1) the advice is provided under an arrangement between the employer or plan fiduciary and the fiduciary adviser for the provision of investment advice by the fiduciary adviser as permitted under the provision; (2) the terms of the arrangement require compliance by the fiduciary adviser with the requirements of the provision; and (3) the terms of the arrangement include a written acknowledgement by the fiduciary adviser that the fiduciary adviser is a plan fiduciary with respect to the provision of the advice.

The provision does not exempt the employer or a plan fiduciary from fiduciary responsibility under ERISA for the prudent selection and periodic review of a fiduciary adviser with whom the employer or plan fiduciary has arranged for the provision of investment advice. The employer or plan fiduciary does not have the duty to monitor the specific investment advice given by a fiduciary adviser. The provision also provides that nothing in the fiduciary responsibility provisions of ERISA is to be construed to preclude the use of plan assets to pay for reasonable expenses in providing investment advice.

***Study and determination by the Secretary of Labor; class exemption***

Under the provision, the Secretary of Labor must determine, in consultation with the Secretary of the Treasury, whether there is any computer model investment advice program that can be used by IRAs and that meets the requirements of the provision. The de-

termination is to be made on the basis of information to be solicited by the Secretary of Labor as described below. Under the provision, a computer model investment advice program must (1) use relevant information about the beneficiary, (2) take into account the full range of investments, including equities and bonds, in determining the options for the investment portfolio of the beneficiary, and (3) allow the account beneficiary, in directing the investment of assets, sufficient flexibility in obtaining advice to evaluate and select options. The Secretary of Labor must report the results of this determination to the House Committees on Ways and Means and Education and the Workforce and the Senate Committees on Finance and Health, Education, Labor, and Pensions no later than December 31, 2007.

As soon as practicable after the date of enactment, the Secretary of Labor, in consultation with the Secretary of the Treasury, must solicit information as to the feasibility of the application of computer model investment advice programs for IRAs, including from (1) at least the top 50 trustees of IRAs, determined on the basis of assets held by such trustees, and (2) other persons offering such programs based on nonproprietary products. The information solicited by the Secretary of Labor from such trustees and other persons is to include information on their computer modeling capabilities with respect to the current year and the preceding year, including their capabilities for investment accounts they maintain. If a person from whom the Secretary of Labor solicits information does not provide such information within 60 days after the solicitation, the person is not entitled to use any class exemption granted by the Secretary of Labor as required under the provision (as discussed below) unless such failure is due to reasonable cause and not willful neglect.

The exemptions provided under the provision with respect to an eligible investment advice arrangement involving a computer model do not apply to IRAs. If the Secretary of Labor determines that there is a computer model investment advice program that can be used by IRAs, the exemptions provided under the provision with respect to an eligible investment advice arrangement involving a computer model can apply to IRAs.

If, as a result of the study of this issue as directed by the provision, the Secretary of Labor determines that there is not such a program, the Secretary of Labor must grant a class exemption from prohibited transaction treatment for (1) the provision of investment advice by a fiduciary adviser to beneficiaries of IRAs; (2) investment transactions pursuant to the advice; and (3) the direct or indirect receipt of fees or other compensation in connection with the provision of the advice or an investment transaction pursuant to the advice. Application of the exemptions are to be subject to conditions as are set forth in the class exemption and as are (1) in the interests of the IRA and its beneficiary and protective of the rights of the beneficiary, and (2) necessary to ensure the requirements of the applicable exemptions are met and the investment advice provided utilizes prescribed objective criteria to provide asset allocation portfolios comprised of securities or other property available as investments under the IRA. Such conditions could require that the fiduciary adviser providing the advice (1) adopt written policies and

procedures that ensure the advice provided is not biased in favor of investments offered by the fiduciary adviser or a related person, and (2) appoint an individual responsible for annually reviewing the advice provided to determine that the advice is provided in accordance with the policies and procedures in (1).

If the Secretary of Labor later determines that there is any computer model investment advice program that can be used by IRAs, the class exemption ceases to apply after the later of (1) the date two years after the Secretary's later determination, or (2) the date three years after the date the exemption first took effect.

Any person may request the Secretary of Labor to make a determination with respect to any computer model investment advice program as to whether it can be used by IRAs, and the Secretary must make such determination within 90 days of the request. If the Secretary determines that the program cannot be so used, within 10 days of the determination, the Secretary must notify the House Committees on Ways and Means and Education and the Workforce and the Senate Committees on Finance and Health, Education, Labor, and Pensions thereof and the reasons for the determination.

### *Effective Date*

The provisions are effective with respect to investment advice provided after December 31, 2006. The provision relating to the study by the Secretary of Labor is effective on the date of enactment (August 17, 2006).

## B. Prohibited Transaction Rules Relating to Financial Investments (sec. 611 of the Act, secs. 408, 412(a), 502(i) and new sec. 3(42) of ERISA, and sec. 4975 of the Code)

### 1. Exemption for block trading

### *Present Law*

Present law provides statutory exemptions from the prohibited transaction rules for certain transactions.[551] Present law does not provide a statutory prohibited transaction exemption for block trades. For purposes of the prohibited transaction rules, a fiduciary means any person who (1) exercises any authority or control respecting management or disposition of the plan's assets, (2) renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has the authority or responsibility to do so, or (3) has any discretionary authority or responsibility in the administration of the plan.

### *Explanation of Provision*

The provision provides prohibited transaction exemptions under ERISA and the Code for a purchase or sale of securities or other property (as determined by the Secretary of Labor) between a plan

[551] In addition, under ERISA section 408(a), the Secretary of Labor may grant exemptions with respect to particular transactions or classes of transactions after consultation and coordination with the Secretary of Treasury. An exemption may not be granted unless the Secretary of Labor finds that the exemption is administratively feasible, in the interests of the plan and its participants and beneficiaries, and protective of the rights of plan participants and beneficiaries.

and a disqualified person (other than a fiduciary) if: (1) the transaction involves a block trade; (2) at the time of the transaction, the interest of the plan (together with the interests of any other plans maintained by the same plan sponsor) does not exceed 10 percent of the aggregate size of the block trade; (3) the terms of the transaction, including the price, are at least as favorable to the plan as an arm's length transaction with an unrelated party; and (4) the compensation associated with the transaction is not greater than the compensation associated with an arm's length transaction with an unrelated party. For purposes of the provision, block trade is defined as any trade of at least 10,000 shares or with a market value of at least $200,000 that will be allocated across two or more unrelated client accounts of a fiduciary. Examples of property other than securities that the Secretary of labor may apply the exemption to include (but are not limited to) future contracts and currency.

### *Effective Date*

The provision is effective with respect to transactions occurring after the date of enactment (August 17, 2006).

### 2. Bonding relief

### *Present Law*

Subject to certain exceptions, ERISA requires a plan fiduciary and any person handling plan assets to be bonded, generally in an amount between $1,000 and $500,000. An exception to the bonding requirement generally applies for a fiduciary (or a director, officer, or employee of the fiduciary) that is a corporation authorized to exercise trust powers or conduct an insurance business if the corporation is subject to supervision or examination by Federal or State regulators and meets certain financial requirements.

### *Explanation of Provision*

The provision provides an exception to the ERISA bonding requirement for an entity registered as a broker or a dealer under the Securities Exchange Act of 1934 if the broker or dealer is subject to the fidelity bond requirements of a self-regulatory organization (within the meaning of the Securities Exchange Act of 1934).

### *Effective Date*

The provision is effective for plan years beginning after the date of enactment (August 17, 2006).

### 3. Exemption for electronic communication network

### *Present Law*

Present law provides statutory exemptions from the prohibited transaction rules for certain transactions.[552] Present law does not

[552] In addition, under ERISA section 408(a), the Secretary of Labor may grant exemptions with respect to particular transactions or classes of transactions after consultation and coordination with the Secretary of Treasury. An exemption may not be granted unless the Secretary of

provide a statutory prohibited transaction exemption for transactions made through an electronic communication network, but such transactions may be permitted if the parties are not known to each other (a "blind" transaction).

### *Explanation of Provision*

The provision provides a prohibited transaction exemption under ERISA and the Code for a transaction involving the purchase or sale of securities (or other property as determined under regulations) between a plan and a disqualified person if: (1) the transaction is executed through an electronic communication network, alternative trading system, or similar execution system or trading venue that is subject to regulation and oversight by (a) the applicable Federal regulating entity or (b) a foreign regulatory entity as the Secretary of Labor may determine under regulations; (2) either (a) neither the execution system nor the parties to the transaction take into account the identity of the parties in the execution of trades, or (b) the transaction is effected under rules designed to match purchases and sales at the best price available through the execution system in accordance with applicable rules of the SEC or other relevant governmental authority; (3) the price and compensation associated with the purchase and sale are not greater than an arm's length transaction with an unrelated party; (4) if the disqualified person has an ownership interest in the system or venue, the system or venue has been authorized by the plan sponsor or other independent fiduciary for this type of transaction; and (5) not less than 30 days before the first transaction of this type executed through any such system or venue, a plan fiduciary is provided written notice of the execution of the transaction through the system or venue.

Examples of other property for purposes of the exemption include (but are not limited to) futures contracts and currency.

### *Effective Date*

The provision is effective with respect to transactions occurring after the date of enactment (August 17, 2006).

## 4. Exemption for service providers

### *Present Law*

Certain transactions are exempt from prohibited transaction treatment if made for adequate consideration. For this purpose, adequate consideration means: (1) in the case of a security for which there is a generally recognized market, either the price of the security prevailing on a national securities exchange registered under the Securities Exchange Act of 1934, or, if the security is not traded on such a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of any disqualified person; and (2) in the case of an asset other than a security for which there is a generally

---

Labor finds that the exemption is administratively feasible, in the interests of the plan and its participants and beneficiaries, and protective of the rights of plan participants and beneficiaries.

recognized market, the fair market value of the asset as determined in good faith by a trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations.[553]

### *Explanation of Provision*

The provision provides a prohibited transaction exemption under ERISA for certain transactions (such as sales of property, loans, and transfers or use of plan assets) between a plan and a person that is a party in interest solely by reason of providing services (or solely by reason of having certain relationships with a service provider, or both), but only if, in connection with the transaction, the plan receives no less, nor pays no more, than adequate consideration. For this purpose, adequate consideration means: (1) in the case of a security for which there is a generally recognized market, the price of the security prevailing on a national securities exchange registered under the Securities Exchange Act of 1934, taking into account factors such as the size of the transaction and marketability of the security, or, if the security is not traded on such a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of the party in interest, taking into account factors such as the size of the transaction and marketability of the security; and (2) in the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by a fiduciary or named fiduciaries in accordance with regulations. The exemption does not apply to a fiduciary (or an affiliate) who has or exercises any discretionary authority or control with respect to the investment of the assets involved in the transaction or provides investment advice with respect to the assets.

### *Effective Date*

The provision is effective with respect to transactions occurring after the date of enactment (August 17, 2006).

## 5. Relief for foreign exchange transactions

### *Present Law*

Present law provides statutory exemptions from the prohibited transaction rules for certain transactions.[554] Present law does not provide a statutory prohibited transaction exemption for foreign exchange transactions.

### *Explanation of Provision*

The provision provides a prohibited transaction exemption under ERISA and the Code for foreign exchange transactions between a

[553] ERISA sec. 3(18).

[554] In addition, under ERISA section 408(a), the Secretary of Labor may grant exemptions with respect to particular transactions or classes of transactions after consultation and coordination with the Secretary of Treasury. An exemption may not be granted unless the Secretary of Labor finds that the exemption is administratively feasible, in the interests of the plan and its participants and beneficiaries, and protective of the rights of plan participants and beneficiaries.

bank or broker-dealer (or an affiliate of either) and a plan in connection with the sale, purchase, or holding of securities or other investment assets (other than a foreign exchange transaction unrelated to any other investment in securities or other investment assets) if: (1) at the time the foreign exchange transaction is entered into, the terms of the transaction are not less favorable to the plan than the terms generally available in comparable arm's length foreign exchange transactions between unrelated parties or the terms afforded by the bank or the broker-dealer (or any affiliate thereof) in comparable arm's-length foreign exchange transactions involving unrelated parties; (2) the exchange rate used for a particular foreign exchange transaction may not deviate by more than three percent from the interbank bid and asked rates at the time of the transaction for transactions of comparable size and maturity as displayed on an independent service that reports rates of exchange in the foreign currency market for such currency; and (3) the bank, broker-dealer (and any affiliate of either) does not have investment discretion or provide investment advice with respect to the transaction.

### *Effective Date*

The provision is effective with respect to transactions occurring after the date of enactment (August 17, 2006).

## 6. Definition of plan asset vehicle

### *Present Law*

Under ERISA regulations, applicable also for purposes of the prohibited transaction rules of the Code, when a plan holds a non-publicly-traded equity interest in an entity, the assets of the entity may be considered plan assets in certain circumstances unless equity participation in the entity by benefit plan inventors is not significant.[555] In general, such equity participation is significant if, immediately after the most recent acquisition of any equity interest in the entity, 25 percent or more of the value of any class of equity interest in the entity (disregarding certain interests) is held by benefit plan investors, defined as (1) employer-sponsored plans (including those exempt from ERISA, such as governmental plans), (2) other arrangements, such as IRAs, that are subject only to the prohibited transaction rules of the Code, and (3) any entity whose assets are plan assets by reason of a plan's investment in the entity.[556] In that case, unless an exception applies, plan assets include the plan's equity interest in the entity and an undivided interest in each of the underlying assets of the entity.

### *Explanation of Provision*

Under the provision, the term "plan assets" means plan assets as defined under regulations prescribed by the Secretary of Labor. Under the regulations, the assets of any entity are not to be treat-

[555] 29 C.F.R. sec. 2510.3–101(a) (2005). As a result, a person who exercises authority or control respecting management or disposition of the assets of the entity or renders investment advice with respect to the assets for a fee (direct or indirect) is a plan fiduciary.

[556] 29 C.F.R. sec. 2510.3–101(f) (2005).

ed as plan assets if, immediately after the most recent acquisition of any equity interest in the entity, less than 25 percent of the total value of each class of equity interest in the entity (disregarding certain interests) is held by benefit plan investors. For this purpose, an entity is considered to hold plan assets only to the extent of the percentage of the equity interest held by benefit plan investors, which means an employee benefit plan subject to the fiduciary rules of ERISA, any plan to which the prohibited transaction rules of the Code applies, and any entity whose underlying assets include plan assets by reason of a plan's investment in such entity.

### *Effective Date*

The provision is effective with respect to transactions occurring after the date of enactment (August 17, 2006).

## 7. Exemption for cross trading

### *Present Law*

Present law provides statutory exemptions from the prohibited transaction rules for certain transactions.[557] Present law does not provide a statutory prohibited transaction exemption for cross trades.

### *Explanation of Provision*

The provision provides prohibited transaction exemptions under ERISA and the Code for a transaction involving the purchase and sale of a security between a plan and any other account managed by the same investment manager if certain requirements are met. These requirements are—

- the transaction is a purchase or sale, for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available;
- the transaction is effected at the independent current market price of the security;
- no brokerage commission, fee (except for customary transfer fees, the fact of which is disclosed) or other remuneration is paid in connection with the transaction;
- a fiduciary (other than the investment manager engaging in the cross trades or any affiliate) for each plan participating in the transaction authorizes in advance of any cross-trades (in a document that is separate from any other written agreement of the parties) the investment manager to engage in cross trades at the investment manager's discretion, after the fiduciary has received disclosure regarding the conditions under which cross trades may take place (but only if the disclosure is separate from any other agreement or disclosure involving the asset management relationship), including the written policies and procedures of the investment manager;

[557] In addition, under ERISA section 408(a), the Secretary of Labor may grant exemptions with respect to particular transactions or classes of transactions after consultation and coordination with the Secretary of Treasury. An exemption may not be granted unless the Secretary of Labor finds that the exemption is administratively feasible, in the interests of the plan and its participants and beneficiaries, and protective of the rights of plan participants and beneficiaries.

- each plan participating in the transaction has assets of at least $100,000,000, except that, if the assets of a plan are invested in a master trust containing the assets of plans maintained by employers in the same controlled group, the master trust has assets of at least $100,000,000;
- the investment manager provides to the plan fiduciary who has authorized cross trading a quarterly report detailing all cross trades executed by the investment manager in which the plan participated during such quarter, including the following information as applicable: the identity of each security bought or sold, the number of shares or units traded, the parties involved in the cross trade, and the trade price and the method used to establish the trade price;
- the investment manager does not base its fee schedule on the plan's consent to cross trading and no other service (other than the investment opportunities and cost savings available through a cross trade) is conditioned on the plan's consent to cross trading;
- the investment manager has adopted, and cross trades are effected in accordance with, written cross-trading policies and procedures that are fair and equitable to all accounts participating in the cross-trading program and that include a description of the manager's pricing policies and procedures, and the manager's policies and procedures for allocating cross trades in an objective manner among accounts participating in the cross-trading program; and
- the investment manager has designated an individual responsible for periodically reviewing purchases and sales to ensure compliance with the written policies and procedures and, following such review, the individual must issue an annual written report no later than 90 days following the period to which it relates, signed under penalty of perjury, to the plan fiduciary who authorized the cross trading, describing the steps performed during the course of the review, the level of compliance, and any specific instances of noncompliance.

The written report must also notify the plan fiduciary of the plan's right to terminate participation in the investment manager's cross-trading program at any time.

No later than 180 days after the date of enactment, the Secretary of Labor, after consultation with the Securities and Exchange Commission, is directed to issue regulations regarding the content of policies and procedures required to be adopted by an investment manager under the requirements for the exemption.

### *Effective Date*

The provision is effective with respect to transactions occurring after the date of enactment (August 17, 2006).

### C. Correction Period for Certain Transactions Involving Securities and Commodities (sec. 612 of the Act, sec. 408 of ERISA, and sec. 4975 of the Code)

#### *Present Law*

ERISA and the Code prohibit certain transactions between an employer-sponsored retirement plan and a disqualified person (referred to as a "party in interest" under ERISA).[558] Disqualified persons include a fiduciary of the plan, a person providing services to the plan, and an employer with employees covered by the plan. For this purpose, a fiduciary includes any person who (1) exercises any authority or control respecting management or disposition of the plan's assets, (2) renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has the authority or responsibility to do so, or (3) has any discretionary authority or responsibility in the administration of the plan.

Prohibited transactions include (1) the sale, exchange or leasing of property, (2) the lending of money or other extension of credit, (3) the furnishing of goods, services or facilities, (4) the transfer to, or use by or for the benefit of, the income or assets of the plan, (5) in the case of a fiduciary, any act that deals with the plan's income or assets for the fiduciary's own interest or account, and (6) the receipt by a fiduciary of any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan. However, certain transactions are exempt from prohibited transaction treatment, for example, certain loans to plan participants.

Under the Code, if a prohibited transaction occurs, the disqualified person who participates in the transaction is subject to a two-tier excise tax. The first level tax is 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period and is 100 percent of the amount involved. Under ERISA, the Secretary of Labor may assess a civil penalty against a person who engages in a prohibited transaction, other than a transaction with a plan covered by the prohibited transaction rules of the Code (i.e., involving a qualified retirement plan or annuity). The penalty may not exceed five percent of the amount involved in the transaction. If the prohibited transaction is not corrected within 90 days after notice from the Secretary of Labor, the penalty may be up to 100 percent of the amount involved in the transaction.[559] For purposes of these rules, the "amount involved" generally means the greater of (1) the amount of money and the fair market value of the other property given, or (2) the amount of money and the fair market

[558] Under ERISA, the prohibited transaction rules apply to employer-sponsored retirement plans and welfare benefit plans. Under the Code, the prohibited transaction rules apply to qualified retirement plans and qualified retirement annuities, as well as individual retirement accounts and annuities, Archer MSAs, health savings accounts, and Coverdell education savings accounts. The prohibited transaction rules under ERISA and the Code generally do not apply to governmental plans or church plans.

[559] A prohibited transaction violates the fiduciary responsibility provisions of ERISA. Under section 502(l) of ERISA, in the case of a violation of fiduciary responsibility, a civil penalty is generally imposed of 20 percent of the amount recovered from a person with respect to the violation in a settlement agreement with the Department of Labor or a judicial proceeding, but the penalty is reduced by the amount of any excise tax or other civil penalty with respect to a prohibited transaction.

value of other property received by the plan. The terms "correction" and "correct" mean, with respect to a prohibited transaction, undoing the transaction to the extent possible, but in any case placing the plan in a financial position not worse than the position in which it would be if the disqualified person were acting under the highest fiduciary standards.

For purposes of the prohibited transaction rules of the Code and ERISA, a transaction involving the sale of securities is considered to occur when the transaction is settled (that is, an actual change in ownership of the securities). Under current practice, securities transactions are commonly settled 3 days after the agreement to sell is made. Present law does not provide a statutory prohibited transaction exemption that is based solely on correction of the transaction.

### *Explanation of Provision*

The Act provides a prohibited transaction exemption under ERISA and the Code for a transaction in connection with the acquisition, holding, or disposition of any security or commodity if the transaction is corrected within a certain period, generally within 14 days of the date the disqualified person (or other person knowingly participating in the transaction) discovers, or reasonably should have discovered, the transaction was a prohibited transaction. For this purpose, the term "correct" means, with respect to a transaction: (1) to undo the transaction to the extent possible and in any case to make good to the plan or affected account any losses resulting from the transaction; and (2) to restore to the plan or affected account any profits made through the use of assets of the plan. If the exemption applies, no excise tax is to be assessed with respect to the transaction, any tax assessed is to be abated, and any tax collected is to be credited or refunded as a tax overpayment.

The exemption does not apply to any transaction between a plan and a plan sponsor or its affiliates that involves the acquisition or sale of an employer security or the acquisition, sale, or lease of employer real property. In addition, in the case of a disqualified person (or other person knowingly participating in the transaction), the exemption does not apply if, at the time of the transaction, the person knew (or reasonably should have known) that the transaction would constitute a prohibited transaction.

### *Effective Date*

The provision is effective with respect to any transaction that a fiduciary or other person discovers, or reasonably should have discovered, after the date of enactment (August 17, 2006) constitutes a prohibited transaction.

## D. Inapplicability of Relief from Fiduciary Liability During Suspension of Ability of Participant or Beneficiary to Direct Investments (sec. 621 of the Act and sec. 404(c) of ERISA)

### *Present Law*

#### *Fiduciary rules under ERISA*

ERISA contains general fiduciary duty standards that apply to all fiduciary actions, including investment decisions. ERISA requires that a plan fiduciary generally must discharge its duties solely in the interests of participants and beneficiaries and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. With respect to plan assets, ERISA requires a fiduciary to diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.

A plan fiduciary that breaches any of the fiduciary responsibilities, obligations, or duties imposed by ERISA is personally liable to make good to the plan any losses to the plan resulting from such breach and to restore to the plan any profits the fiduciary has made through the use of plan assets. A plan fiduciary may be liable also for a breach of responsibility by another fiduciary (a "co-fiduciary") in certain circumstances.

#### *Special rule for participant control of assets*

ERISA provides a special rule in the case of a defined contribution plan that permits participants to exercise control over the assets in their individual accounts. Under the special rule, if a participant exercises control over the assets in his or her account (as determined under regulations), the participant is not deemed to be a fiduciary by reason of such exercise and no person who is otherwise a fiduciary is liable for any loss, or by reason of any breach, that results from the participant's exercise of control.

Regulations issued by the Department of Labor describe the requirements that must be met in order for a participant to be treated as exercising control over the assets in his or her account. With respect to investment options, the regulations provide in part:

- the plan must provide at least three different investment options, each of which is diversified and has materially different risk and return characteristics;
- the plan must allow participants to give investment instructions with respect to each investment option under the plan with a frequency that is appropriate in light of the reasonably expected market volatility of the investment option (the general volatility rule);
- at a minimum, participants must be allowed to give investment instructions at least every three months with respect to least three of the investment options, and those investment options must constitute a broad range of options (the three-month minimum rule);

- participants must be provided with detailed information about the investment options, information regarding fees, investment instructions and limitations, and copies of financial data and prospectuses; and
- specific requirements must be satisfied with respect to investments in employer stock to ensure that employees' buying, selling, and voting decisions are confidential and free from employer influence.

If these and the other requirements under the regulations are met, a plan fiduciary may be liable for the investment options made available under the plan, but not for the specific investment decisions made by participants.

***Blackout notice***

Under ERISA, the plan administrator of a defined contribution plan generally must provide at least 30 days advance notice of a blackout period (a "blackout notice") to plan participants and beneficiaries to whom the blackout period applies.[560] Failure to provide a blackout notice may result in a civil penalty up to $100 per day for each failure with respect to a single participant or beneficiary.

A blackout period is any period during which any ability of participants or beneficiaries under the plan, which is otherwise available under the terms of the plan, to direct or diversify assets credited to their accounts, or to obtain loans or distributions from the plan, is temporarily suspended, limited, or restricted if the suspension, limitation, or restriction is for any period of more than three consecutive business days. However, a blackout period does not include a suspension, limitation, or restriction that (1) occurs by reason of the application of securities laws, (2) is a change to the plan providing for a regularly scheduled suspension, limitation, or restriction that is disclosed through a summary of material modifications to the plan or materials describing specific investment options under the plan, or changes thereto, or (3) applies only to one or more individuals, each of whom is a participant, alternate payee, or other beneficiary under a qualified domestic relations order.

A blackout notice must be written in a manner calculated to be understood by the average plan participant and must include (1) the reasons for the blackout period, (2) an identification of the investments and other rights affected, (3) the expected beginning date and length of the blackout period, and (4) in the case of a blackout period affecting investments, a statement that the participant or beneficiary should evaluate the appropriateness of current investment decisions in light of the inability to direct or diversify assets during the blackout period, and (5) other matters as required by regulations. If the expected beginning date or length of the blackout period changes after notice has been provided, the plan administrator must provide notice of the change (and specify any material change in other matters related to the blackout) to affected participants and beneficiaries as soon as reasonably practicable.

[560] ERISA sec. 101(i).

### *Explanation of Provision*

The Act amends the special rule applicable if a participant exercises control over the assets in his or her account with respect to a case in which a qualified change in investment options offered under the defined contribution plan occurs. In such a case, for purposes of the special rule, a participant or beneficiary who has exercised control over the assets in his or her account before a change in investment options is not treated as not exercising control over such assets in connection with the change if certain requirements are met.

For this purpose, a qualified change in investment options means a change in the investment options offered to a participant or beneficiary under the terms of the plan, under which: (1) the participant's account is reallocated among one or more remaining or new investment options offered instead of one or more investment options that were offered immediately before the effective date of the change; and (2) the characteristics of the remaining or new investment options, including characteristics relating to risk and rate of return, are, immediately after the change, reasonably similar to the characteristics of the investment options immediately before the change.

The following requirements must be met in order for the rule to apply: (1) at least 30 but not more than 60 days before the effective date of the change in investment options, the plan administrator furnishes written notice of the change to participants and beneficiaries, including information comparing the existing and new investment options and an explanation that, in the absence of affirmative investment instructions from the participant or beneficiary to the contrary, the account of the participant or beneficiary will be invested in new options with characteristics reasonably similar to the characteristics of the existing investment options; (2) the participant or beneficiary has not provided to the plan administrator, in advance of the effective date of the change, affirmative investment instructions contrary to the proposed reinvestment of the participant's or beneficiary's account; and (3) the investment of the participant's or beneficiary's account as in effect immediately before the effective date of the change was the product of the exercise by such participant or beneficiary of control over the assets of the account.

In addition, the provision amends the special rule applicable if a participant or beneficiary exercises control over the assets in his or her account so that the provision under which no person who is otherwise a fiduciary is liable for any loss, or by reason of any breach, that results from the participant's or beneficiary's exercise of control does not apply in connection with a blackout period[561] in which the participant's or beneficiary's ability to direct the assets in his or her account is suspended by a plan sponsor or fiduciary. However, if a plan sponsor or fiduciary meets the requirements of ERISA in connection with authorizing and implementing a blackout period, any person who is otherwise a fiduciary is not

[561] For this purpose, blackout period is defined as under the present-law provision requiring advance notice of a blackout period.

liable under ERISA for any loss occurring during the blackout period.

Not later than one year after the date of enactment, the Secretary of Labor is to issue interim final regulations providing guidance, including safe harbors, on how plan sponsors or other affected fiduciaries can satisfy their fiduciary responsibilities during any blackout period.

### *Effective Date*

The provision generally applies to plan years beginning after December 31, 2007. In the case of a plan maintained pursuant to one or more collective bargaining agreements, the provision is effective for plan years beginning after the earlier of (1) the later of December 31, 2008, or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after the date of enactment (August 17, 2006)), or (2) December 31, 2009.

## E. Increase in Maximum Bond Amount (sec. 622 of the Act and sec. 412(a) of ERISA)

### *Present Law*

ERISA generally requires every plan fiduciary and every person who handles funds or other property of a plan (a "plan official") to be bonded. The amount of the bond is fixed annually at no less than ten percent of the funds handled, but must be at least $1,000 and not more than $500,000 (unless the Secretary of Labor prescribes a larger amount after notice and an opportunity to be heard). The bond is intended to protect plans against loss from acts of fraud or dishonesty by plan officials. Qualifying bonds must have as surety a corporate surety company that is an acceptable surety on Federal bonds.

### *Explanation of Provision*

The provision raises the maximum bond amount to $1 million in the case of a plan that holds employer securities. A plan would not be considered to hold employer securities within the meaning of this section where the only securities held by the plan are part of a broadly diversified fund of assets, such as mutual or index funds.

### *Effective Date*

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

## F. Increase in Penalties for Coercive Interference with Exercise of ERISA Rights (sec. 623 of the Act and sec. 511 of ERISA)

### *Present Law*

ERISA prohibits any person from using fraud, force or violence (or threatening force or violence) to restrain, coerce, or intimidate (or attempt to) any plan participant or beneficiary in order to inter-

fere with or prevent the exercise of their rights under the plan or ERISA. Willful violation of this prohibition is a criminal offense subject to a $10,000 fine or imprisonment of up to one year, or both.

### *Explanation of Provision*

The provision increases the penalties for willful acts of coercive interference with participants' rights under a plan or ERISA. The amount of the fine is increased to $100,000, and the maximum term of imprisonment is increased to 10 years.

### *Effective Date*

The provision is effective for violations occurring on and after the date of enactment (August 17, 2006).

## G. Treatment of Investment of Assets by Plan Where Participant Fails to Exercise Investment Election (sec. 624 of the Act and sec. 404(c) of ERISA)

### *Present Law*

ERISA imposes standards on the conduct of plan fiduciaries, including persons who make investment decisions with respect to plan assets. Fiduciaries are personally liable for any losses to the plan due to a violation of fiduciary standards.

An individual account plan may permit participants to make investment decisions with respect to their accounts. ERISA fiduciary liability does not apply to investment decisions made by plan participants if participants exercise control over the investment of their individual accounts, as determined under ERISA regulations. In that case, a plan fiduciary may be responsible for the investment alternatives made available, but not for the specific investment decisions made by participants.

### *Explanation of Provision*

Under the provision, a participant in an individual account plan meeting certain notice requirements is treated as exercising control over the assets in the account with respect to the amount of contributions and earnings which, in the absence of an investment election by the participant, are invested by the plan in accordance with regulations prescribed by the Secretary of Labor. The regulations are to provide guidance on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both. The Secretary of Labor is directed to issue regulations under the provision within six months of the date of enactment (August 17, 2006).

In order for this treatment to apply, each participant must receive, within a reasonable period of time before each plan year, a notice explaining (1) the participant's right under the plan to designate how contributions and earnings will be invested and (2) how, in the absence of any investment election by the participant, such contributions and earnings will be invested. The participant must also have a reasonable period of time after receipt of the no-

tice and before the beginning of the plan year to make an investment designation. The notice must be sufficiently accurate and comprehensive to apprise the participant of his or her rights and obligations and written in a manner to be understood by the average participant.

### *Effective Date*

The provision is effective for plan years beginning after December 31, 2006.

## H. Clarification of Fiduciary Rules (sec. 625 of the Act)

### *Present Law*

ERISA imposes standards on the conduct of plan fiduciaries. Fiduciaries are personally liable for any losses to the plan due to a violation of fiduciary standards.

An ERISA interpretive bulletin requires a fiduciary choosing an annuity provider for purposes of distributions from a plan (whether on separation or retirement of a participant or on termination of the plan) to take steps calculated to obtain the safest available annuity, based on the annuity provider's claims paying ability and creditworthiness, unless under the circumstances it would be in the interest of participants to do otherwise.[562]

### *Explanation of Provision*

The provision directs the Secretary of Labor to issue final regulations within one year of the date of enactment (August 17, 2006), clarifying that the selection of an annuity contract as an optional form of distribution from a defined contribution plan is not subject to the safest available annuity requirement under the ERISA interpretive bulletin and is subject to all otherwise applicable fiduciary standards.

The regulations to be issued by the Secretary of Labor are intended to clarify that the plan sponsor or other applicable plan fiduciary is required to act in accordance with the prudence standards of ERISA section 404(a). It is not intended that there be a single safest available annuity contract since the plan fiduciary must select the most prudent option specific to its plan and its participants and beneficiaries. Furthermore, it is not intended that the regulations restate all of the factors contained in the interpretive bulletin.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

[562] 29 C.F.R. sec. 2509.95–1 (2005).

## TITLE VII—BENEFIT ACCRUAL STANDARDS (secs. 701–702 of the Act, secs. 203, 204 and 205 of ERISA, secs. 411 and 417 of the Code, and sec. 4(i) of ADEA)

### *Present Law*

#### *Prohibition on age discrimination*

*In general*

A prohibition on age discrimination applies to benefit accruals under a defined benefit pension plan.[563] Specifically, an employee's benefit accrual may not cease, and the rate of an employee's benefit accrual may not be reduced, because of the attainment of any age. However, this prohibition is not violated solely because the plan imposes (without regard to age) a limit on the amount of benefits that the plan provides or a limit on the number of years of service or years of participation that are taken into account for purposes of determining benefit accrual under the plan. Moreover, for purposes of this requirement, the subsidized portion of any early retirement benefit may be disregarded in determining benefit accruals.

In December 2002, the IRS issued proposed regulations that dealt with the application of the age discrimination rules.[564] The proposed regulations included rules for applying the age discrimination rules with respect to accrued benefits, optional forms ofbenefit, ancillary benefits, and other rights and features provided under a plan. Under the proposed regulations, for purposes of applying the prohibition on age discrimination to defined benefit pension plans, an employee's rate of benefit accrual for a year is generally the increase in the employee's accrued normal retirement benefit (i.e., the benefit payable at normal retirement age) for the plan year. In the preamble to the proposed regulations, the IRS requested comments on other approaches to determining the rate of benefit accrual, such as allowing accrual rates to be averaged over multiple years (for example, to accommodate plans that provide a higher rate of accrual in earlier years) or, in the case of a plan that applies an offset, determining accrual rates before application of the offset. As discussed below, in June 2004, the IRS announced the withdrawal of the proposed regulations.

*Cash balance and other hybrid plans*

Certain types of defined benefit pension plans, such as cash balance plans and pension equity plans, are referred to as "hybrid" plans because they combine features of a defined benefit pension plan and a defined contribution plan.

---

[563] Code sec. 411(b)(1)(H); ERISA sec. 204(b)(1)(H).
[564] 67 Fed. Reg. 76123.

Under a cash balance plan, benefits are determined by reference to a hypothetical account balance. An employee's hypothetical account balance is determined by reference to hypothetical annual allocations to the account ("pay credits") (e.g., a certain percentage of the employee's compensation for the year) and hypothetical earnings on the account ("interest credits"). Cash balance plans are generally designed so that, when a participant receives a pay credit for a year of service, the participant also receives the right to future interest on the pay credit, regardless of whether the participant continues employment (referred to as "front-loaded" interest credits). That is, the participant's hypothetical account continues to be credited with interest after the participant stops working for the employer. As a result, if an employee terminates employment and defers distribution to a later date, interest credits will continue to be credited to that employee's hypothetical account.

Another type of hybrid plan is a pension equity plan (sometimes referred to as a "PEP"). Under a pension equity plan, benefits are generally described as a percentage of final average pay, with the percentage determined on the basis of points received for each year of service, which are often weighted for older or longer service employees. Pension equity plans commonly provide interest credits for the period between a participant's termination of employment and commencement of benefits.

Because of the front-loaded nature of accruals under cash balance plans, there is a longer time for interest credits to accrue on a pay credit to the account of a younger employee. Thus, a pay credit received at a younger age may provide a larger annuity benefit at normal retirement age than the same pay credit received at an older age. A similar effect may occur with respect to other types of hybrid plan designs, including pension equity plans.

IRS consideration of cash balance plans began in the early 1990s.[565] At that time, the focus was on the question of whether such plans satisfied the nondiscrimination requirements under section 401(a)(4), which requires that benefits or contributions not discriminate in favor of highly compensated employees. Treasury regulations issued in 1991 under section 401(a)(4) provided a safe harbor for cash balance plans that provide frontloaded interest credits and meet certain other requirements. In connection with the issuance of these regulations, Treasury spoke to the cash balance age discrimination issue. The preamble to the final regulations stated "[t]he fact that interest adjustments through normal retirement age are accrued in the year of the related hypothetical allocation will not cause a cash balance plan to fail to satisfy the requirements of section 411(b)(1)(H), relating to age-based reductions in the rate at which benefits accrue under a plan."[566] Many interpreted this language as Treasury's position that cash balance plan designs do not violate the prohibitions on age discrimination. The IRS has not to date asserted that hybrid plan formulas result in per se violations of age discrimination requirements. In 1999, Treasury and the IRS issued an announcement and a Federal Register notice stating that the question of whether cash balance con-

[565] Statement of Stuart L. Brown, Chief Counsel Internal Revenue Service, before the Senate Committee on Health, Education, Labor, and Pensions (Sept. 21, 1999).
[566] 56 Fed. Reg. 47528 (Sept. 19, 1991).

versions were age discriminatory or otherwise inconsistent with plan qualification rules was under active consideration, that further IRS determination letters on conversions to cash balance plans would therefore be suspended and requests referred to the IRS National Office until the IRS and Treasury had resolved the issues, and inviting public comment on the issues. Hundreds of comments were submitted. The December 2002 proposed regulations, noted above, provided that an employee's rate of benefit accrual for a year is generally the increase in the employee's accrued normal retirement benefit (i.e., the benefit payable at normal retirement age) for the plan year. However, the proposed regulations provided a special rule under which an employee's rate of benefit accrual under a cash balance plan meeting certain requirements (an "eligible" cash balance plan) was based on the rate of pay credit provided under the plan. Thus, under the proposed regulations, an eligible cash balance plan would not violate the prohibition on age discrimination solely because pay credits for younger employees earn interest credits for a longer period.

Section 205 of the Consolidated Appropriations Act, 2004 (the "2004 Appropriations Act"), enacted January 24, 2004, provides that none of the funds made available in the 2004 Appropriations Act may be used by the Secretary of the Treasury, or his designee, to issue any rule or regulation implementing the 2002 proposed Treasury age discrimination regulations or any regulation reaching similar results.[567] The 2004 Appropriations Act also required the Secretary of the Treasury within 180 days of enactment to present to Congress a legislative proposal for providing transition relief for older and longer-service participants affected by conversions of their employers' traditional pension plans to cash balance plans. The Treasury Department complied with this requirement by including in the President's budget for fiscal year 2005 a proposal relating to cash balance and other hybrid plans that specifically addresses conversions to such plans, the application of the age discrimination rules to such plans, and the determination of minimum lump sums under such plans.[568] In June 2004, the IRS announced the withdrawal of the proposed age discrimination regulations, including the special rules for eligible cash balance plans.[569] According to the Announcement, "[t]his will provide Congress an opportunity to . . . address cash balance and other hybrid plan issues through legislation."

The application of the age discrimination rules to hybrid plans has been the subject of litigation. The decisions are divided on how ERISA requires courts to calculate the rate of benefit accrual.[570]

---

[567] Pub. L. No. 108–199 (2004).

[568] A similar proposal was also contained in the President's budget proposal for fiscal year 2006.

[569] IRS Announcement 2004–57, 2004–27 I.R.B. 15.

[570] Compare *Register* v. *PNC Financial Services Group, Inc.* No. 04–CV–6097, 2005 WL 3120268 (E.D. Pa. Nov. 21, 2005), *Tootle* v. *ARINC, Inc.*, 222 F.R.D. 88 (D. Md. 2004); *Eaton* v. *Oanan Corp.*, 117 F. Supp. 2d 812 (S.D. Ind. 2000); with *Cooper* v. *IBM Personal Pension Plan*, 274 F. Supp. 2d 1010 (S.D. Ill. 2003), *Richards* v. *Fleetboston Financial Corp.*, 427 F. Supp. 2d 150 (D. Conn. 2006), *Donaldson* v. *Pharmacia Pension Plan*, 2006 WL 1669789, 38 E.B.C. 1006 (S.D. Ill. June 14, 2006). See also *Campbell* v. *BankBoston*, 327 F.3d 1 (1st Cir. 2003) and *Hirt* v. *Equitable Retirement Plan for Employees, Managers and Agents* No. 01 Civ. 7920 (AKH), 2006 WL 2023545 (S.D.N.Y. July 20, 2006).

### *Calculating minimum lump-sum distributions under hybrid plans*

Defined benefit pension plans, including cash balance plans and other hybrid plans, are required to provide benefits in the form of a life annuity commencing at a participant's normal retirement age. If the plan permits benefits to be paid in certain other forms, such as a lump sum, minimum present value rules apply, under which the alternative form of benefit cannot be less than the present value of the life annuity payable at normal retirement age, determined using certain statutorily prescribed interest and mortality assumptions.[571]

Most cash balance plans are designed to permit a lump-sum distribution of a participant's hypothetical account balance upon termination of employment. This raises an issue as to the whether a distribution of a participant's hypothetical account balance satisfies the minimum present value rules. In 1996, the IRS issued proposed guidance (Notice 96–8) on the application of the minimum present value rules to lump-sum distributions under cash balance plans and requested public comments in anticipation of proposed regulations incorporating the proposed guidance.[572]

Under the proposed guidance, a lump-sum distribution from a cash balance plan cannot be less than the present value of the benefit payable at normal retirement age, determined using the statutory interest and mortality assumptions. For this purpose, a participant's normal retirement benefit under a cash balance plan is generally determined by projecting the participant's hypothetical account balance to normal retirement age by crediting to the account future interest credits at the plan rate, the right to which has already accrued, and converting the projected account balance to an actuarially equivalent life annuity payable at normal retirement age, using the interest and mortality assumptions specified in the plan. The proposed guidance also included rules under which cash balance plans can provide lump-sum distributions in the amount of participants' hypothetical account balances if the rate at which interest credits are provided under the plan is not greater (or is assumed not to be greater) than the statutory interest rate.

Under the approach in the proposed guidance, a difference in the rate of interest credits provided under the plan, which is used to project the account balance forward to normal retirement age, and the statutory rate used to determine the lump-sum value (i.e., present value) of the accrued benefit can cause a discrepancy between the value of the minimum lump-sum and the employee's hypothetical account balance. This effect is sometimes referred to as "whipsaw." In particular, if the plan's interest crediting rate is higher than the statutory interest rate, then the resulting lump-

[571] Code sec. 417(e); ERISA sec. 205(g)(3). For years before 1995, these provisions required the use of an interest rate based on interest rates determined by the PBGC. For years after 1994, these provisions require the use of an interest rate based on interest rates on 30-year Treasury securities and a mortality table specified by the IRS.

[572] Notice 96–8, 1996–1996–1 C.B. 359. The Notice provides that regulations will be effective prospectively and, for plan years before regulations are effective, allows lump-sum distributions from cash balance plans that provide front-loaded interest credits to be based on a reasonable, good-faith interpretation of the minimum present value rules, taking into account preexisting guidance. The Notice further provides that plans that comply with the guidance in the Notice are deemed to be applying a reasonable, good-faith interpretation.

sum amount will generally be greater than the hypothetical account balance.

Several courts, but not all, have applied an approach similar to the approach in the proposed guidance in cases involving the determination of lump sums under cash balance plans.[573] Regulations addressing the application of the minimum present value rules to cash balance plans have not been issued.[574]

### *Explanation of Provision*

#### *Age discrimination rules in general*

Under the provision, a plan is not treated as violating the prohibition on age discrimination under ERISA, the Code, and ADEA if a participant's accrued benefit,[575] as determined as of any date under the terms of the plan would be equal to or greater than that of any similarly situated, younger individual who is or could be a participant. For this purpose, an individual is similarly situated to a participant if the individual and the participant are (and always have been) identical in every respect (including period of service, compensation, position, date of hire, work history, and any other respect) except for age. Under the provision, the comparison of benefits for older and younger participants applies to all possible participants under all possible dates under the plan, in the same manner as the present-law application of the backloading and accrual rules.

In addition, in determining a participant's accrued benefit for this purpose, the subsidized portion of any early retirement benefit or any retirement type subsidy is disregarded. In some cases the value of an early retirement subsidy may be difficult to determine; it is therefore intended that a reasonable approximation of such value may be used for this purpose. In calculating the accrued benefit, the benefit may, under the terms of the plan, be calculated as an annuity payable at normal retirement age, the balance of a hypothetical account, or the current value of the accumulated percentage of the employee's final average compensation. That is, the age discrimination rules may be applied on the basis of the balance of a hypothetical account or the current value of the accumulated percentage of the employee's final average compensation, but only if the plan terms provide the accrued benefit in such form. The provision is intended to apply to hybrid plans, including pension equity plans.

---

[573] *Berger* v. *Xerox Corp. Retirement Income Guarantee Plan*, 338 F.3d 755 (7th Cir. 2003); *Esden* v. *Bank of Boston*, 229 F.3d 154 (2d Cir. 2000), cert. dismissed, 531 U.S. 1061 (2001); *Lyons* v. *Georgia Pacific Salaried Employees Retirement Plan*, 221 F.3d 1235 (11th Cir. 2000) ("*Lyons II*"), cert. denied, 532 U.S. 967 (2001); and *West* v. *AK Steel Corp. Retirement Accumulation Plan*, 318 F. Supp.2d 579 (S.D. Ohio 2004). In *Lyons II*, the court reversed a lower court holding in *Lyons* v. *Georgia Pacific Salaried Employees Retirement Plan*, 66 F. Supp. 2d 1328 (N.D. Ga. 1999) ("*Lyons I*"), relating to the application of the minimum present value rules in effect before 1995. The *Lyons II* court limited its analysis to the minimum present value rules in effect as of 1993 when Mr. Lyons received his lump-sum distribution; however, the court indicated that a different result could apply under the law in effect after 1994. On remand, in *Lyons* v. *Georgia Pacific Salaried Employees Retirement Plan*, 196 F. Supp. 2d 1260 (N.D. Ga. 2002) ("*Lyons III*"), the lower court determined that payment of the hypothetical account balance did not violate the minimum present value rules in effect for years after 1994.

[574] As mentioned above, the President's budgets for fiscal years 2005 and 2006 include a proposal relating to cash balance plans that specifically addresses the determination of minimum lump sums under such plans. The President's proposal would eliminate the whipsaw effect and allow the plan to pay the hypothetical account balance, if certain requirements are satisfied.

[575] For purposes of this rule, the accrued benefit means such benefit accrued to date.

The provision makes it clear that a plan is not treated as age discriminatory solely because the plan provides offsets of benefits under the plan to the extent such offsets are allowable in applying the requirements under section 401(a) of the Code. It is intended that such offsets also comply with ERISA and the ADEA.

A plan is not treated as failing to meet the age discrimination requirements solely because the plan provides a disparity in contributions and benefits with respect to which the requirements of section 401(l) of the Code are met.

A plan is not treated as failing to meet the age discrimination requirements solely because the plan provides for indexing of accrued benefits under the plan. Except in the case of any benefit provided in the form of a variable annuity, this rule does not apply with respect to any indexing which results in an accrued benefit less than the accrued benefit determined without regard to such indexing. Indexing for this purpose means, with respect to an accrued benefit, the periodic adjustment of the accrued benefit by means of the application of a recognized investment index or methodology. Under the provision, in no event may indexing be reduced or cease because of age.

***Rules for applicable defined benefit plans***

*In general*

Under the provision, an applicable defined benefit plan fails to satisfy the age discrimination rules unless the plan meets certain requirements with respect to interest credits and, in the case of a conversion, certain additional requirements. Applicable defined benefit plans must also satisfy certain vesting requirements.

*Interest requirement*

A plan satisfies the interest requirement if the terms of the plan provide that any interest credit (or equivalent amount) for any plan year is at a rate that is not less than zero and is not greater than a market rate of return. A plan does not fail to meet the interest requirement merely because the plan provides for a reasonable minimum guaranteed rate of return or for a rate or return that is equal to the greater of a fixed or variable rate of return. An interest credit (or an equivalent amount) of less than zero cannot result in the account balance or similar amount being less than the aggregate amount of contributions credited to the account. The Secretary of the Treasury may provide rules governing the calculation of a market rate of return and for permissible methods of crediting interest to the account (including fixed or variable interest rates) resulting in effective rates of return that meet the requirements of the provision.

If the interest credit rate (or equivalent amount) is a variable rate, the plan must provide that, upon termination of the plan, the rate of interest used to determine accrued benefits under the plan is equal to the average of the rates of interest used under the plan during the five-year period ending on the termination date.

*Conversion rules*

Under the provision, special rules apply if an amendment to a defined benefit plan is adopted which would have the effect of converting the plan into an applicable defined benefit plan (an "applicable plan amendment").[576] If an applicable plan amendment is adopted after June 29, 2005, the plan fails to satisfy the age discrimination rules unless the plan provides that the accrued benefit of any individual who was a participant immediately before the adoption of the amendment is not less than the sum of (1) the participant's accrued benefit for years of service before the effective date of the amendment, determined under the terms of the plan as in effect before the amendment; plus (2) the participant's accrued benefit for years of service after the effective date of the amendment, determined under the terms of the plan as in effect after the terms of the amendment.

For purposes of determining the amount in (1) above, the plan must credit the accumulation account or similar amount with the amount of any early retirement benefit or retirement-type subsidy for the plan year in which the participant retires if, as of such time, the participant has met the age, years of service, and other requirements under the plan for entitlement to such benefit or subsidy.

*Vesting rules*

The provision amends the ERISA and Code rules relating to vesting to provide that an applicable defined benefit plan must provide that each employee who has completed at least three years of serves has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions.

*Minimum present value rules*

The provision provides that an applicable defined benefit plan is not treated as failing to meet the minimum present value rules[577] solely because of the present value of the accrued benefit (or any portion thereof) of any participant is, under the terms of the plan, equal to the amount expressed as the balance in the hypothetical account or as an accumulated percentage of the participant's final average compensation.

*Rules on plan termination*

The provision provides rules for making determinations of benefits upon termination of an applicable defined benefit plan. Such a plan must provide that, upon plan termination, (1) if the interest credit rate (or equivalent amount) under the plan is a variable rate, the rate of interest used to determine accrued benefits under

[576] If the benefits under two or more defined benefit plans established by an employer are coordinated in such a manner as to have the effect of the adoption of an applicable plan amendment, the sponsor of the defined benefit plan or plans providing for the coordination is treated as having adopted an applicable plan amendment as of the date the coordination begins. In addition, the Secretary of Treasury is directed to issue regulations to prevent the avoidance of the requirements with respect to an applicable plan amendment through the use of two or more plan amendments rather than a single amendment.

[577] ERISA sec. 205(g), Code sec. 417(e). A plan complying with the provision also does not violate certain rules relating to vesting (ERISA sec. 203(a)(2) and Code sec. 411(a)(2)) and the determination of the accrued benefit (in the case of a plan which does not provide for employee contributions) (ERISA sec. 204(c) and Code sec. 411(c)).

the plan shall be equal to the average of the rates of interest used under the plan during the five-year period ending on the termination date and (2) the interest rate and mortality table used to determine the amount of any benefit under the plan payable in the form of an annuity payable at normal retirement age is the rate and table specified under the plan for such purposes as of the termination date. For purposes of (2), if the rate of interest is a variable rate, then the rate is the average of such rates during the five-year period ending on the termination date.

*Definition of applicable defined benefit plan*

An applicable defined benefit plan is a defined benefit plan under which the accrued benefit (or any portion thereof) is calculated as the balance of a hypothetical account maintained for the participant or as an accumulated percentage of the participant's final average compensation. The Secretary of the Treasury is to provide rules which include in the definition of an applicable defined benefit plan any defined benefit plan (or portion of such a plan) which has an effect similar to an applicable defined benefit plan.

***No inference***

Nothing in the provision is to be construed to infer the treatment of applicable defined benefit plans or conversions to such plans under the rules in ERISA, ADEA and the Code prohibiting age discrimination[578] as in effect before the provision is effective. In addition, no inference is to be drawn with respect to the application of the minimum benefit rules to applicable defined benefit plans before the provision is effective.

***Regulations relating to mergers and acquisitions***

The Secretary of the Treasury is directed to prescribe regulations for the application of the provisions relating to applicable defined benefit plans in cases where the conversion of a plan to a cash balance or similar plan is made with respect to a group of employees who become employees by reason of a merger, acquisition, or similar treatment. The regulations are to be issued not later than 12 months after the date of enactment (August 17, 2006).

### *Effective Date*

In general, the provision is effective for periods beginning on or after June 29, 2005.

The provision relating to the minimum value rules is effective for distributions after the date of enactment (August 17, 2006).

In the case of a plan in existence on June 29, 2005, the interest credit and vesting requirements for an applicable defined benefit plan generally apply to years beginning after December 31, 2007, except that the plan sponsor may elect to have such requirements apply for any period after June 29, 2005, and before the first plan year beginning after December 31, 2007. In the case of a plan maintained pursuant to one or more collective bargaining agreements, a delayed effective date applies with respect to the interest

[578] ERISA sec. 204(b)(1)(H), ADEA sec. 4(i)(1), and Code sec. 411(b)(1)(H).

credit and vesting requirements for an applicable defined benefit plan.

The provision relating to conversions of plans applies to plan amendments adopted after and taking effect after June 29, 2005, except that a plan sponsor may elect to have such amendments apply to plan amendments adopted before and taking affect after such date.

The direction to the Secretary of the Treasury to issue regulations relating to mergers and acquisitions is effective on the date of enactment (August 17, 2006).

# TITLE VIII—PENSION RELATED REVENUE PROVISIONS

## A. Deduction Limitations

### 1. Increase in deduction limits applicable to single-employer and multiemployer defined benefit pension plans (secs. 801 and 802 of the Act and sec. 404 of the Code)

#### *Present Law*

***In general***

Employer contributions to qualified retirement plans are deductible subject to certain limits.

In the case of contributions to a defined benefit pension plan (including both single-employer and multiemployer plans), the employer generally may deduct the greater of: (1) the amount necessary to satisfy the minimum funding requirement of the plan for the year; or (2) the amount of the plan's normal cost for the year plus the amount necessary to amortize certain unfunded liabilities over 10 years, but limited to the full funding limitation for the year.[579] The maximum amount otherwise deductible generally is not less than the plan's unfunded current liability.[580] In the case of a single-employer plan covered by the PBGC insurance program that terminates during the year, the maximum deductible amount is generally not less than the amount needed to make the plan assets sufficient to fund benefit liabilities as defined for purposes of plan termination under the PBGC insurance program ("unfunded termination liability"). In applying these limits, future increases in the limits on compensation taken into account under a qualified retirement plan and on benefits payable under a defined benefit pension plan may not be taken into account.

In the case of a defined contribution plan, the employer generally may deduct contributions in an amount up to 25 percent of compensation paid or accrued during the employer's taxable year.

***Overall deduction limit***

If an employer sponsors one or more defined benefit pension plans and one or more defined contribution plans that cover at least one of the same employees, an overall deduction limit applies to the total contributions to all plans for a plan year. The overall deduction limit is the greater of (1) 25 percent of compensation, or

[579] The full funding limitation is the excess, if any, of (1) the accrued liability of the plan (including normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets. However, the full funding limit is not less than the excess, if any, of 90 percent of the plan's current liability (including the current liability normal cost) over the actuarial value of plan assets.

[580] In the case of a plan with 100 or fewer participants, unfunded current liability for this purpose does not include the liability attributable to benefit increases for highly compensated employees resulting from a plan amendment that is made or becomes effective, whichever is later, within the last two years.

(2) the amount necessary to meet the minimum funding requirement with respect to the defined benefit plan for the year. For this purpose, the amount necessary to meet the minimum funding requirement with respect to the defined benefit plan is treated as not less than the amount of the plan's unfunded current liability.

Subject to certain exceptions, an employer that makes nondeductible contributions to a plan is subject to an excise tax equal to 10 percent of the amount of the nondeductible contributions for the year.

### *Explanation of Provision*

#### *Single-employer defined benefit pension plans*

*General deduction limit*

Under the provision, for taxable years beginning in 2006 and 2007, in the case of contributions to a single-employer defined benefit plan, the maximum deductible amount is not less than the excess (if any) of (1) 150 percent of the plan's current liability, over (2) the value of plan assets.

For taxable years beginning after 2007, in the case of contributions to a single-employer defined benefit pension plan, the maximum deductible amount is equal to the greater of: (1) the excess (if any) of the sum of the plan's funding target, the plan's target normal cost, and a cushion amount for a plan year, over the value of plan assets (as determined under the minimum funding rules);[581] and (2) the minimum required contribution for the plan year.[582]

However, in the case of a plan that is not in at-risk status, the first amount above is not less than the excess (if any) of the sum of the plan's funding target and target normal cost, determined as if the plan was in at-risk status, over the value of plan assets.

The cushion amount for a plan year is the sum of (1) 50 percent of the plan's funding target for the plan year; and (2) the amount by which the plan's funding target would increase if determined by taking into account increases in participants' compensation for future years or, if the plan does not base benefits attributable to past service on compensation, increases in benefits that are expected to occur in succeeding plans year, determined on the basis of average annual benefit increases over the previous six years.[583] For this purpose, the dollar limits on benefits and on compensation apply, but, in the case of a plan that is covered by the PBGC insurance program, increases in the compensation limit (under sec. 401(a)(17)) that are expected to occur in succeeding plan years may be taken into account.[584] The rules relating to projecting compensa-

[581] In determining the maximum deductible amount, the value of plan assets is not reduced by any pre-funding balance or funding standard account carryover balance.

[582] The Act retains the present-law rule, under which, in the case of a single-employer plan covered by the PBGC that terminates during the year, the maximum deductible amount is generally not less than the amount needed to make the plan assets sufficient to fund benefit liabilities as defined for purposes of the PBGC termination insurance program.

[583] In determining the cushion amount for a plan with 100 or fewer participants, a plan's funding target does not include the liability attributable to benefit increases for highly compensated employees resulting from a plan amendment that is made or becomes effective, whichever is later, within the last two years.

[584] Expected increases in the limitations on benefits under section 415, however, may not be taken into account.

tion for future years are intended solely to enable employers to reduce volatility in pension contributions; the rules are not intended to create any inference that employees have any protected interest with respect to such projected increases.

*Overall deduction limit*

Under the provision, in applying the overall deduction limit to contributions to one or more defined benefit pension plans and one or more defined contribution plans for years beginning after December 31, 2007, single-employer defined benefit pension plans that are covered by the PBGC insurance program are not taken into account. Thus, the deduction for contributions to a defined benefit pension plan or a defined contribution plan is not affected by the overall deduction limit merely because employees are covered by both plans if the defined benefit plan is covered by the PBGC insurance program (i.e., the separate deduction limits for contributions to defined contribution plans and defined benefit pension plans apply). In addition, in applying the overall deduction limit, the amount necessary to meet the minimum funding requirement with respect to a single-employer defined benefit pension plan that is not covered by the PBGC insurance program is treated as not less than the plan's funding shortfall (as determined under the minimum funding rules).

***Multiemployer defined benefit pension plans***

*General deduction limit*

Under the provision, for taxable years beginning after 2005, in the case of contributions to a multiemployer defined benefit pension plan, the maximum deductible amount is not less than the excess (if any) of (1) 140 percent of the plan's current liability, over (2) the value of plan assets.

*Overall deduction limit*

Under the provision, for taxable years beginning after December 31, 2005, in applying the overall deduction limit to contributions to one or more defined benefit pension plans and one or more defined contribution plans, multiemployer plans are not taken into account. Thus, the deduction for contributions to a defined benefit pension plan or a defined contribution plan is not affected by the overall deduction limit merely because employees are covered by both plans if either plan is a multiemployer plan (i.e., the separate deduction limits for contributions to defined contribution plans and defined benefit pension plans apply).

### *Effective Date*

The effective dates of the provisions regarding deductions are described above under each provision.

### 2. Updating deduction rules for combination of plans (sec. 803 of the Act and secs. 404(a)(7) and 4972 of the Code)

#### *Present Law*

Employer contributions to qualified retirement plans are deductible subject to certain limits.[585] In general, the deduction limit depends on the kind of plan.[586]

If an employer sponsors one or more defined benefit pension plans and one or more defined contribution plans that cover at least one of the same employees, an overall deduction limit applies to the total contributions to all plans for a plan year. The overall deduction limit is the greater of (1) 25 percent of compensation, or (2) the amount necessary to meet the minimum funding requirements of the defined benefit plan for the year, but not less than the amount of the plan's unfunded current liability.

Under EGTRRA, elective deferrals are not subject to the limits on deductions and are not taken into account in applying the limits to other employer contributions. The combined deduction limit of 25 percent of compensation for defined benefit and defined contribution plans does not apply if the only amounts contributed to the defined contribution plan are elective deferrals.[587]

Subject to certain exceptions, an employer that makes nondeductible contributions to a plan is subject to an excise tax equal to 10 percent of the amount of the nondeductible contributions for the year. Certain contributions to a defined contribution plan that are nondeductible solely because of the overall deduction limit are disregarded in determining the amount of nondeductible contributions for purposes of the excise tax. Contributions that are disregarded are the greater of (1) the amount of contributions not in excess of six percent of the compensation of the employees covered by the defined contribution plan, or (2) the amount of matching contributions.

#### *Explanation of Provision*

Under the provision, the overall limit on employer deductions for contributions to combinations of defined benefit and defined contribution plans applies to contributions to one or more defined contribution plans only to the extent that such contributions exceed six percent of compensation otherwise paid or accrued during the taxable year to the beneficiaries under the plans. As under present law, for purposes of determining the excise tax on nondeductible contributions, matching contributions to a defined contribution plan that are nondeductible solely because of the overall deduction limit are disregarded.

#### *Effective Date*

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

---

[585] Code sec. 404.

[586] See the discussion under A.1., above, for a description of the deduction rules for defined benefit and defined contribution plans.

[587] Under the general EGTRRA sunset, this rule expires for plan years beginning after 2010.

## B. Certain Pension Provisions Made Permanent

### 1. Permanency of EGTRRA pension and IRA provisions (sec. 811 of the Act and Title X of EGTRRA)

#### *Present Law*

***In general***

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") made a number of changes to the Federal tax laws, including a variety of provisions relating to pensions and individual retirement arrangements ("IRAs"). However, 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.[588]

***List of affected provisions***

Following is a list of the provisions affected by the general EGTRRA sunset.

*Individual retirement arrangements ("IRAs")*

- Increases in the IRA contribution limits, including the ability to make catch-up contributions (secs. 219, 408, and 408A of the Code and sec. 601 of EGTRRA); and
- Rules relating to deemed IRAs under employer plans (sec. 408(q) of the Code and sec. 602 of EGTRRA).

*Expanding coverage*

- Increases in the limits on contributions, benefits, and compensation under qualified retirement plans, tax-sheltered annuities, and eligible deferred compensation plans (secs. 401(a)(17), 402(g), 408(p), 414(v), 415, and 457 of the Code and sec. 611 of EGTRRA);
- Application of prohibited transaction rules to plan loans of S corporation owners, partners, and sole proprietors (sec. 4975 of the Code and sec. 612 of EGTRRA);
- Modification of the top-heavy rules (sec. 416 of the Code and sec. 613 of EGTRRA);
- Elective deferrals not taken into account for purposes of deduction limits (sec. 404 of the Code and sec. 614 of EGTRRA);

[588] The saver's credit (sec. 25B) expires at the end of 2006. Another provision of the Act makes the saver's credit permanent.

• Repeal of coordination requirements for deferred compensation plans of state and local governments and tax-exempt organizations (sec. 457 of the Code and sec. 615 of EGTRRA);
• Modifications to deduction limits (sec. 404 of the Code and sec. 616 of EGTRRA);
• Option to treat elective deferrals as after-tax Roth contributions (sec. 402A of the Code and sec. 617 of EGTRRA);
• Credit for pension plan start-up costs (sec. 45E of the Code and sec. 619 of EGTRRA); and
• Certain nonresident aliens excluded in applying minimum coverage requirements (secs. 410(b)(3) and 861(a)(3) of the Code and sec. 621 of EGTRRA).

*Enhancing fairness*

• Catch-up contributions for individuals age 50 and older (sec. 414 of the Code and sec. 631 of EGTRRA);
• Equitable treatment for contributions of employees to defined contribution plans (secs. 403(b), 415, and 457 of the Code and sec. 632 of EGTRRA);
• Faster vesting of employer matching contributions (sec. 411 of the Code and sec. 633 of EGTRRA);
• Modifications to minimum distribution rules (sec. 401(a)(9) of the Code and sec. 634 of EGTRRA);
• Clarification of tax treatment of division of section 457 plan benefits upon divorce (secs. 414(p) and 457 of the Code and sec. 635 of EGTRRA);
• Provisions relating to hardship withdrawals (secs. 401(k) and 402 of the Code and sec. 636 of EGTRRA); and
• Waiver of tax on nondeductible contributions for domestic and similar workers (sec. 4972(c)(6) of the Code and sec. 637 of EGTRRA).

*Increasing portability*

• Rollovers of retirement plan and IRA distributions (secs. 401, 402, 403(b), 408, 457, and 3405 of the Code and secs. 641–644 of EGTRRA);
• Treatment of forms of distribution (sec. 411(d)(6) of the Code and sec. 645 of EGTRRA);
• Rationalization of restrictions on distributions (secs. 401(k), 403(b), and 457 of the Code and sec. 646 of EGTRRA):
• Purchase of service credit under governmental pension plans (secs. 403(b) and 457 of the Code and sec. 647 of EGTRRA):
• Employers may disregard rollovers for purposes of cash-out rules (sec. 411(a)(11) of the Code and sec. 648 of EGTRRA); and
• Minimum distribution and inclusion requirements for section 457 plans (sec. 457 of the Code and sec. 649 of EGTRRA).

*Strengthening pension security and enforcement*

• Phase in repeal of 160 percent of current liability funding limit; maximum deduction rules (secs. 404(a)(1), 412(c)(7), and 4972(c) of the Code and secs. 651–652 of EGTRRA);

- Excise tax relief for sound pension funding (sec. 4972 of the Code and sec. 653 of EGTRRA);
- Modifications to section 415 limits for multiemployer plans (sec. 415 of the Code and sec. 654 of EGTRRA);
- Investment of employee contributions in 401(k) plans (sec. 655 of EGTRRA);
- Prohibited allocations of stock in an S corporation ESOP (secs. 409 and 4979A of the Code and sec. 656 of EGTRRA);
- Automatic rollovers of certain mandatory distributions (secs. 401(a)(31) and 402(f)(1) of the Code and sec. 657 of EGTRRA);
- Clarification of treatment of contributions to a multiemployer plan (sec. 446 of the Code and sec. 658 of EGTRRA); and
- Treatment of plan amendments reducing future benefit accruals (sec. 4980F of the Code and sec. 659 of EGTRRA).

*Reducing regulatory burdens*

- Modification of timing of plan valuations (sec. 412 of the Code and sec. 661 of EGTRRA);
- ESOP dividends may be reinvested without loss of dividend deduction (sec. 404 of the Code and sec. 662 of EGTRRA);
- Repeal transition rule relating to certain highly compensated employees (sec. 663 of EGTRRA);
- Treatment of employees of tax-exempt entities for purposes of nondiscrimination rules (secs. 410, 401(k), and 401(m) of the Code and sec. 664 of EGTRRA);
- Treatment of employer-provided retirement advice (sec. 132 of the Code and sec. 665 of EGTRRA); and
- Repeal of the multiple use test (sec. 401(m) of the Code and sec. 666 of EGTRRA).

### *Explanation of Provision*

The provision repeals the sunset provision of EGTRRA as applied to the provisions relating to pensions and IRAs.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## 2. Saver's credit made permanent (sec. 812 of the Act and sec. 25B of the Code)

### *Present Law*

Present law provides a temporary nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions. The maximum annual contribution eligible for the credit is $2,000. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. 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 older, 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 "section 457 plan"), a SIMPLE, 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 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 credit rates based on AGI are provided in Table 1, below.

**Table 1.—Credit Rates for Saver's Credit**

| Joint filers | Heads of households | All other filers | Credit rate |
|---|---|---|---|
| $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 credit does not apply to taxable years beginning after December 31, 2006.

### *Explanation of Provision*

The provision makes the saver's credit permanent.

### *Effective Date*

The extension of the saver's credit is effective on the date of enactment (August 17, 2006).[589]

[589] In addition, another provision of Act, described below, provides for indexing of the income limits on the saver's credit.

## C. Improvements in Portability, Distribution, and Contribution Rules

### 1. Purchase of permissive service credit (sec. 821 of the Act, and secs. 403(b)(13), 415(n)(3), and 457(e)(17) of the Code)

#### *Present Law*

***In general***

Present law imposes limits on contributions and benefits under qualified plans.[590] The limits on contributions and benefits under qualified plans are based on the type of plan. Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of (1) a certain dollar amount ($175,000 for 2006) or (2) 100 percent of the participant's average compensation for his or her high three years.

A qualified retirement plan maintained by a State or local government employer may provide that a participant may make after-tax employee contributions in order to purchase permissive service credit, subject to certain limits.[591]

In the case of any repayment of contributions and earnings to a governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan (oranother plan maintained by a State or local government employer within the same State), any such repayment is not taken into account for purposes of the section 415 limits on contributions and benefits. Also, service credit obtained as a result of such a repayment is not considered permissive service credit for purposes of the section 415 limits.

***Permissive service credit***

*Definition of permissive service credit*

Permissive service credit means credit for a period of service recognized by the governmental plan which the participant has not received under the plan and which the employee receives only if the employee voluntarily contributes to the plan an amount (as determined by the plan) that does not exceed the amount necessary to fund the benefit attributable to the period of service and that is in addition to the regular employee contributions, if any, under the plan.

The IRS has ruled that credit is not permissive service credit where it is purchased to provide enhanced retirement benefits for a period of service already credited under the plan, as the enhanced benefit is treated as credit for service already received.[592]

*Nonqualified service*

Service credit is not permissive service credit if more than five years of permissive service credit is purchased for nonqualified service or if nonqualified service is taken into account for an employee who has less than five years of participation under the plan.

---

[590] Sec. 415.
[591] Sec. 415(n)(3).
[592] Priv. Ltr. Rul. 200229051 (April 26, 2002).

Nonqualified service is service other than service (1) as a Federal, State or local government employee, (2) as an employee of an association representing Federal, State or local government employees, (3) as an employee of an educational institution which provides elementary or secondary education, as determined under State law, or (4) for military service. Service under (1), (2) and (3) is nonqualified service if it enables a participant to receive a retirement benefit for the same service under more than one plan.

***Trustee-to-trustee transfers to purchase permissive service credit***

Under EGTRRA, a participant is not required to include in gross income a direct trustee- to-trustee transfer to a governmental defined benefit plan from a section 403(b) annuity or a section 457 plan if the transferred amount is used (1) to purchase permissive service credit under the plan, or (2) to repay contributions and earnings with respect to an amount previously refunded under a forfeiture of service credit under the plan (or another plan maintained by a State or local government employer within the same State).[593]

## *Explanation of Provision*

***Permissive service credit***

The provision modifies the definition of permissive service credit by providing that permissive service credit means service credit which relates to benefits to which the participant is not otherwise entitled under such governmental plan, rather than service credit which such participant has not received under the plan. Credit qualifies as permissive service credit if it is purchased to provide an increased benefit for a period of service already credited under the plan (e.g., if a lower level of benefit is converted to a higher benefit level otherwise offered under the same plan) as long as it relates to benefits to which the participant is not otherwise entitled.

The provision allows participants to purchase credit for periods regardless of whether service is performed, subject to the limits on nonqualified service.

Under the provision, service as an employee of an educational organization providing elementary or secondary education can be determined under the law of the jurisdiction in which the service was performed. Thus, for example, permissive service credit can be granted for time spent teaching outside of the United States without being considered nonqualified service credit.

***Trustee-to-trustee transfers to purchase permissive service credit***

The provision provides that the limits regarding nonqualified service are not applicable in determining whether a trustee-to-trustee transfer from a section 403(b) annuity or a section 457 plan to a governmental defined benefit plan is for the purchase of permissive service credit. Thus, failure of the transferee plan to satisfy

[593] Secs. 403(b)(13) and 457(e)(17).

the limits does not cause the transferred amounts to be included in the participant's income. As under present law, the transferee plan must satisfy the limits in providing permissive service credit as a result of the transfer.

The provision provides that trustee-to-trustee transfers under sections 457(e)(17) and 403(b)(13) may be made regardless of whether the transfer is made between plans maintained by the same employer. The provision also provides that amounts transferred from a section 403(b) annuity or a section 457 plan to a governmental defined benefit plan to purchase permissive service credit are subject to the distribution rules applicable under the Internal Revenue Code to the defined benefit plan.

### *Effective Date*

The provision is generally effective as if included in the amendments made by section 1526 of the Taxpayer Relief Act of 1997, except that the provision regarding trustee-to-trustee transfers is effective as if included in the amendments made by section 647 of the Economic Growth and Tax Relief Reconciliation Act of 2001.

## 2. Rollover of after-tax amounts in annuity contracts (sec. 822 of the Act and sec. 402(c)(2) of the Code)

### *Present Law*

Employee after-tax contributions may be rolled over from a tax-qualified retirement plan into another tax-qualified retirement plan, if the plan to which the rollover is made is a defined contribution plan, the rollover is accomplished through a direct rollover, and the plan to which the rollover is made provides for separate accounting for such contributions (and earnings thereon). After-tax contributions can also be rolled over from a tax-sheltered annuity (a "section 403(b) annuity") to another tax-sheltered annuity if the rollover is a direct rollover, and the annuity to which the rollover is made provides for separate accounting for such contributions (and earnings thereon). After-tax contributions may also be rolled over to an IRA. If the rollover is to an IRA, the rollover need not be a direct rollover and the IRA owner has the responsibility to keep track of the amount of after-tax contributions.[594]

### *Explanation of Provision*

The provision allows after-tax contributions to be rolled over from a qualified retirement plan to another qualified retirement plan (either a defined contribution or a defined benefit plan) or to a tax-sheltered annuity. As under present law, the rollover must be a direct rollover, and the plan to which the rollover is made must separately account for after-tax contributions (and earnings thereon).

### *Effective Date*

The provision is effective for taxable years beginning after December 31, 2006.

[594] Sec. 402(c)(2); IRS Notice 2002–3, 2002–2 I.R.B. 289.

### 3. Application of minimum distribution rules to governmental plans (sec. 823 of the Act)

#### *Present Law*

Minimum distribution rules apply to tax-favored retirement arrangements, including governmental plans. In general, under these rules, distribution of minimum benefits must begin no later than the required beginning date. Minimum distribution rules also apply to benefits payable with respect to a plan participant who has died. Failure to comply with the minimum distribution rules results in an excise tax imposed on the plan participant equal to 50 percent of the required minimum distribution not distributed for the year. The excise tax may be waived in certain cases.

In the case of distributions prior to the death of the plan participant, the minimum distribution rules are satisfied if either (1) the participant's entire interest in the plan is distributed by the required beginning date, or (2) the participant's interest in the plan is to be distributed (in accordance with regulations) beginning not later than the required beginning date, over a permissible period. The permissible periods are (1) the life of the participant, (2) the lives of the participant and a designated beneficiary, (3) the life expectancy of the participant, or (4) the joint life and last survivor expectancy of the participant and a designated beneficiary. In calculating minimum required distributions from account-type arrangements (e.g., a defined contribution plan or an individual retirement arrangement), life expectancies of the participant and the participant's spouse generally may be recomputed annually.

The required beginning date generally is April 1 of the calendar year following the later of (1) the calendar year in which the participant attains age 70½ or (2) the calendar year in which the participant retires.

The minimum distribution rules also apply to distributions to beneficiaries of deceased participants. In general, if the participant dies after minimum distributions have begun, the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death. If the participant dies before minimum distributions have begun, then the entire remaining interest must generally be distributed within five years of the participant's death. The five-year rule does not apply if distributions begin within one year of the participant's death and are payable over the life of a designated beneficiary or over the life expectancy of a designated beneficiary. A surviving spouse beneficiary is not required to begin distributions until the date the deceased participant would have attained age 70½. In addition, if the surviving spouse makes a rollover from the plan into a plan or IRA of his or her own, the minimum distribution rules apply separately to the surviving spouse.

#### *Explanation of Provision*

The provision directs the Secretary of the Treasury to issue regulations under which a governmental plan is treated as complying with the minimum distribution requirements, for all years to which such requirements apply, if the plan complies with a reasonable,

good faith interpretation of the statutory requirements. It is intended that the regulations apply for periods before the date of enactment (August 17, 2006).

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## 4. Allow direct rollovers from retirement plans to Roth IRAs (sec. 824 of the Act and sec. 408A(e) of the Code)

### *Present Law*

#### *IRAs in general*

There are two general types of individual retirement arrangements ("IRAs"): traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs.

#### *Traditional IRAs*

An individual may make deductible contributions to an IRA up to the lesser of a dollar limit (generally $4,000 for 2006)[595] or the individual's compensation if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan.[596] If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction limit is phased out for taxpayers with adjusted gross income ("AGI") over certain levels for the taxable year. A different, higher, income phaseout applies in the case of an individual who is not an active participant in an employer sponsored plan but whose spouse is.

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to a traditional IRA.

Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Includible amounts withdrawn prior to attainment of age 59½ are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, or is used for certain specified purposes.

#### *Roth IRAs*

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contributions that can be made to all of an individuals IRAs (both traditional and Roth) cannot exceed the maximum deductible IRA contribution limit. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with income above certain levels.

---

[595] The dollar limit is scheduled to increase until it is $5,000 in 2008–2010. Individuals age 50 and older may make additional, catch-up contributions.

[596] In the case of a married couple, deductible IRA contributions of up to the dollar limit can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) which is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to the 10-percent early withdrawal tax (unless an exception applies). The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs.

***Rollover contributions***

If certain requirements are satisfied, a participant in a tax-qualified retirement plan, a tax-sheltered annuity (sec. 403(b)), or a governmental section 457 plan may roll over distributions from the plan or annuity into a traditional IRA. Distributions from such plans may not be rolled over into a Roth IRA.

Taxpayers with modified AGI of $100,000 or less generally may roll over amounts in a traditional IRA into a Roth IRA.[597] The amount rolled over is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply. Married taxpayers who file separate returns cannot roll over amounts in a traditional IRA into a Roth IRA. Amounts that have been distributed from a tax-qualified retirement plan, a tax-sheltered annuity, or a governmental section 457 plan may be rolled over into a traditional IRA, and then rolled over from the traditional IRA into a Roth IRA.

## *Explanation of Provision*

The provision allows distributions from tax-qualified retirement plans, tax-sheltered annuities, and governmental 457 plans to be rolled over directly from such plan into a Roth IRA, subject to the present law rules that apply to rollovers from a traditional IRA into a Roth IRA. For example, a rollover from a tax-qualified retirement plan into a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions), and the 10-percent early distribution tax does not apply. Similarly, an individual with AGI of $100,000 or more could not roll over amounts from a tax-qualified retirement plan directly into a Roth IRA.

## *Effective Date*

The provision is effective for distributions made after December 31, 2007.

[597] Under the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109–222), the $100,000 limit is repealed for taxable years beginning after December 31, 2009.

### 5. Eligibility for participation in eligible deferred compensation plans (sec. 825 of the Act and sec. 457 of the Code)

#### *Present Law*

A section 457 plan is an eligible deferred compensation plan of a State or local government or tax-exempt employer that meets certain requirements. In some cases, different rules apply under section 457 to governmental plans and plans of tax-exempt employers.

Amounts deferred under an eligible deferred compensation plan of a non-governmental tax-exempt organization are includible in gross income for the year in which amounts are paid or made available. Under present law, if the amount payable to a participant does not exceed $5,000, a plan may allow a distribution up to $5,000 without such amount being treated as made available if the distribution can be made only if no amount has been deferred under the plan by the participant during the two-year period ending on the date of the distribution and there has been no prior distribution under the plan. Prior to the Small Business Job Protection Act of 1996, under former section 457(e)(9), benefits were not treated as made available because a participant could elect to receive a lump sum payable after separation from service and within 60 days of the election if (1) the total amount payable under the plan did not exceed $3,500 and (2) no additional amounts could be deferred under the plan.

#### *Explanation of Provision*

Under the provision, an individual is not precluded from participating in an eligible deferred compensation plan by reason of having received a distribution under section 457(e)(9) as in effect before the Small Business Job Protection Act of 1996.

#### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

### 6. Modifications of rules governing hardships and unforeseen financial emergencies (sec. 826 of the Act)

#### *Present Law*

Distributions from a qualified cash or deferred arrangement (a "section 401(k) plan"), a tax-shelter annuity, section 457 plan, or nonqualified deferred compensation plan subject to section 409A may not be made prior to the occurrence of one or more specified events. In the case of a section 401(k) plan or tax-sheltered annuity, one event upon which distribution is permitted is the case of a hardship. Similarly, distributions from section 457 plans and nonqualified deferred compensation plans subject to section 409A may be made in the case of an unforeseeable emergency. Under regulations, a hardship or unforeseeable emergency includes a hardship or unforeseeable emergency of a participant's spouse or dependent.

### *Explanation of Provision*

The provision directs the Secretary of the Treasury to revise the rules for determining whether a participant has had a hardship or unforeseeable emergency to provide that if an event would constitute a hardship or unforeseeable emergency under the plan if it occurred with respect to the participant's spouse or dependent, such event shall, to the extent permitted under the plan, constitute a hardship or unforeseeable emergency if it occurs with respect to a beneficiary under the plan. The provision requires that the revised rules be issued within 180 days after the date of enactment (August 17, 2006).

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## 7. Treatment of distributions to individuals called to active duty for at least 179 days (sec. 827 of the Act and sec. 72(t) of the Code)

### *Present Law*

Under present law, a taxpayer who receives a distribution from a qualified retirement plan prior to age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception to the tax applies. Among other exceptions, the early distribution tax does not apply to distributions made to an employee who separates from service after age 55, or to distributions that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the employee or the joint lives (or life expectancies) of the employee and his or her beneficiary.

Certain amounts held in a qualified cash or deferred arrangement (a "401(k) plan") or in a tax-sheltered annuity (a "403(b) annuity") may not be distributed before severance from employment, age 59½, death, disability, or financial hardship of the employee.

### *Explanation of Provision*

Under the provision, the 10-percent early withdrawal tax does not apply to a qualified reservist distribution. A qualified reservist distribution is a distribution (1) from an IRA or attributable to elective deferrals under a 401(k) plan, 403(b) annuity, or certain similar arrangements, (2) made to an individual who (by reason of being a member of a reserve component as defined in section 101 of title 37 of the U.S. Code) was ordered or called to active duty for a period in excess of 179 days or for an indefinite period, and (3) that is made during the period beginning on the date of such order or call to duty and ending at the close of the active duty period. A 401(k) plan or 403(b) annuity does not violate the distribution restrictions applicable to such plans by reason of making a qualified reservist distribution.

An individual who receives a qualified reservist distribution may, at any time during the two-year period beginning on the day after the end of the active duty period, make one or more contributions

to an IRA of such individual in an aggregate amount not to exceed the amount of such distribution. The dollar limitations otherwise applicable to contributions to IRAs do not apply to any contribution made pursuant to the provision. No deduction is allowed for any contribution made under the provision.

This provision applies to individuals ordered or called to active duty after September 11, 2001, and before December 31, 2007. The two-year period for making recontributions of qualified reservist distributions does not end before the date that is two years after the date of enactment (August 17, 2006).

### *Effective Date*

The provision applies to distributions after September 11, 2001. If refund or credit of any overpayment of tax resulting from the provision would be prevented at any time before the close of the one-year period beginning on the date of the enactment by the operation of any law or rule of law (including res judicata), such refund or credit may nevertheless be made or allowed if claim therefor is filed before the close of such period.

## 8. Inapplicability of 10-percent additional tax on early distributions of pension plans of public safety employees (sec. 828 of the Act and sec. 72(t) of the Code)

### *Present Law*

Under present law, a taxpayer who receives a distribution from a qualified retirement plan prior to age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception to the tax applies. Among other exceptions, the early distribution tax does not apply to distributions made to an employee who separates from service after age 55, or to distributions that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the employee or the joint lives (or life expectancies) of the employee and his or her beneficiary.

### *Explanation of Provision*

Under the provision, the 10-percent early withdrawal tax does not apply to distributions from a governmental defined benefit pension plan to a qualified public safety employee who separates from service after age 50. A qualified public safety employee is an employee of a State or political subdivision of a State if the employee provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such State or political subdivision.

### *Effective Date*

The provision is effective for distributions made after the date of enactment (August 17, 2006).

## 9. Rollovers by nonspouse beneficiaries (sec. 829 of the Act and sec. 402 of the Code)

### *Present Law*

#### *Tax-free rollovers*

Under present law, a distribution from a qualified retirement plan, a tax-sheltered annuity ("section 403(b) annuity"), an eligible deferred compensation plan of a State or local government employer (a "governmental section 457 plan"), or an individual retirement arrangement (an "IRA") generally is included in income for the year distributed. However, eligible rollover distributions may be rolled over tax free within 60 days to another plan, annuity, or IRA.[598]

In general, an eligible rollover distribution includes any distribution to the plan participant or IRA owner other than certain periodic distributions, minimum required distributions, and distributions made on account of hardship.[599] Distributions to a participant from a qualified retirement plan, a tax-sheltered annuity, or a governmental section 457 plan generally can be rolled over to any of such plans or an IRA.[600] Similarly, distributions from an IRA to the IRA owner generally are permitted to be rolled over into a qualified retirement plan, a tax-sheltered annuity, a governmental section 457 plan, or another IRA.

Similar rollovers are permitted in the case of a distribution to the surviving spouse of the plan participant or IRA owner, but not to other persons.

If an individual inherits an IRA from the individual's deceased spouse, the IRA may be treated as the IRA of the surviving spouse. This treatment does not apply to IRAs inherited from someone other than the deceased spouse. In such cases, the IRA is not treated as the IRA of the beneficiary. Thus, for example, the beneficiary may not make contributions to the IRA and cannot roll over any amounts out of the inherited IRA. Like the original IRA owner, no amount is generally included in income until distributions are made from the IRA. Distributions from the inherited IRA must be made under the rules that apply to distributions to beneficiaries, as described below.

#### *Minimum distribution rules*

Minimum distribution rules apply to tax-favored retirement arrangements. In the case of distributions prior to the death of the participant, distributions generally must begin by the April 1 of the calendar year following the later of the calendar year in which the participant (1) attains age 70½ or (2) retires.[601] The minimum dis-

---

[598] 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. Sec. 402(c)(3)(B).

[599] Sec. 402(c)(4). Certain other distributions also are not eligible rollover distributions, e.g., corrective distributions of elective deferrals in excess of the elective deferral limits and loans that are treated as deemed distributions.

[600] Some restrictions or special rules may apply to certain distributions. For example, after-tax amounts distributed from a plan can be rolled over only to a plan of the same type or to an IRA.

[601] In the case of five-percent owners and distributions from an IRA, distributions must begin by the April 1 of the calendar year following the year in which the individual attains age 70½.

tribution rules also apply to distributions following the death of the participant. If minimum distributions have begun prior to the participant's death, the remaining interest generally must be distributed at least as rapidly as under the minimum distribution method being used prior to the date of death. If the participant dies before minimum distributions have begun, then either (1) the entire remaining interest must be distributed within five years of the death, or (2) distributions must begin within one year of the death over the life (or life expectancy) of the designated beneficiary. A beneficiary who is the surviving spouse of the participant is not required to begin distributions until the date the deceased participant would have attained age 70½. Alternatively, if the surviving spouse makes a rollover from the plan into a plan or IRA of his or her own, minimum distributions generally would not need to begin until the surviving spouse attains age 70½.

### *Explanation of Provision*

The provision provides that benefits of a beneficiary other than a surviving spouse may be transferred directly to an IRA. The IRA is treated as an inherited IRA of the nonspouse beneficiary. Thus, for example, distributions from the inherited IRA are subject to the distribution rules applicable to beneficiaries. The provision applies to amounts payable to a beneficiary under a qualified retirement plan, governmental section 457 plan, or a tax-sheltered annuity. To the extent provided by the Secretary, the provision applies to benefits payable to a trust maintained for a designated beneficiary to the same extent it applies to the beneficiary.

### *Effective Date*

The provision is effective for distributions after December 31, 2006.

## 10. Direct deposit of tax refunds in an IRA (sec. 830 of the Act)

### *Present Law*

Under current IRS procedures, a taxpayer may direct that his or her tax refund be deposited into a checking or savings account with a bank or other financial institution (such as a mutual fund, brokerage firm, or credit union) rather than having the refund sent to the taxpayer in the form of a check.

### *Explanation of Provision*

The Secretary is directed to develop forms under which all or a portion of a taxpayer's refund may be deposited in an IRA of the taxpayer (or the spouse of the taxpayer in the case of a joint return). The provision does not modify the rules relating to IRAs, including the rules relating to timing and deductibility of contributions.

### *Effective Date*

The form required by the provision is to be available for taxable years beginning after December 31, 2006.

## 11. Additional IRA contributions for certain employees (sec. 831 of the Act and secs. 25B and 219 of the Code)

### *Present Law*

Under present law, favored tax treatment applies to qualified retirement plans maintained by employers and to individual retirement arrangements ("IRAs").

Qualified defined contribution plans may permit both employees and employers to make contributions to the plan. Under a qualified cash or deferred arrangement (commonly referred to as a "section 401(k) plan"), employees may elect to make pretax contributions to a plan, referred to as elective deferrals. Employees may also be permitted to make after-tax contributions to a plan. In addition, a plan may provide for employer nonelective contributions or matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes elective deferrals or after-tax contributions. Matching contributions are employer contributions that are made only if the employee makes elective deferrals or after-tax contributions. Matching contributions are sometimes made in the form of employer stock.

Under present law, an individual may generally make contributions to an IRA for a taxable year up to the lesser of a certain dollar amount or the individual's compensation. The maximum annual dollar limit on IRA contributions to IRAs is $4,000 for 2005–2007 and $5,000 for 2008, with indexing thereafter. Individuals who have attained age 50 may make additional "catch-up" contributions to an IRA for a taxable year of up to $500 for 2005 and $1,000 for 2006 and thereafter.[602]

### *Explanation of Provision*

Under the provision, an applicable individual may elect to make additional IRA contributions of up to $3,000 per year for 2007–2009. An applicable individual must have been a participant in a section 401(k) plan under which the employer matched at least 50 percent of the employee's contributions to the plan with stock of the employer. In addition, in a taxable year preceding the taxable year of an additional contribution: (1) the employer (or any controlling corporation of the employer) must have been a debtor in a bankruptcy case, and (2) the employer or any other person must have been subject to an indictment or conviction resulting from business transactions related to the bankruptcy. The individual must also have been a participant in the section 401(k) plan on the date six months before the bankruptcy case was filed. An applicable individual who elects to make these additional IRA contributions is not permitted to make IRA catch-up contributions that apply to individuals age 50 and older.

[602] These IRA limits were 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.

### *Effective Date*

The provision is effective for taxable years beginning after December 31, 2006, and before January 1, 2010.

## 12. Special rule for computing high-three average compensation for benefit limitation purposes (sec. 832 of the Act and sec. 415(b)(3) of the Code)

### *Present Law*

Annual benefits payable to a participant under a defined benefit pension plan generally may not exceed the lesser of (1) 100 percent of average compensation for the participant's high three years, or (2) $175,000 (for 2006). The dollar limit is reduced proportionately for individuals with less than 10 years of participation in the plan. The compensation limit is reduced proportionately for individuals with less than 10 years of service.

For purposes of determining average compensation for a participant's high three years, the high three years are the period of consecutive calendar years (not more than three) during which the participant was both an active participant in the plan and had the greatest aggregate compensation from the employer.

### *Explanation of Provision*

Under the provision, for purposes of determining average compensation for a participant's high three years, the high three years are the period of consecutive calendar years (not more than three) during which the participant had the greatest aggregate compensation from the employer.

### *Effective Date*

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

## 13. Inflation indexing of gross income limitations on certain retirement savings incentives (sec. 833 of the Act and secs. 25A and 219 of the Code)

### *Present Law*

#### *Saver's credit*

Present law provides a temporary nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions. The maximum annual contribution eligible for the credit is $2,000. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. 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 older, other than individuals who are full-

time students or claimed as a dependent on another taxpayer's return.

Under present law, the saver's credit expires after 2006.

### *Individual retirement arrangements*

#### *In general*

There are two general types of individual retirement arrangements ("IRAs") under present law: traditional IRAs,[603] to which both deductible and nondeductible contributions may be made,[604] and Roth IRAs.[605]

The maximum annual deductible and nondeductible contributions that can be made to a traditional IRA and the maximum contribution that can be made to a Roth IRA by or on behalf of an individual varies depending on the particular circumstances, including the individual's income. However, the contribution limits for IRAs are coordinated so that the maximum annual contribution that can be made to all of an individual's IRAs is the lesser of a certain dollar amount ($4,000 for 2006) or the individual's compensation. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. For this purpose, the dollar limit is increased by a certain dollar amount ($1,000 for 2006).[606]

#### *Traditional IRAs*

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income over certain levels for the taxable year. The adjusted gross income phase-out ranges are: (1) for single taxpayers, $50,000 to $60,000; (2) for married taxpayers filing joint returns, $75,000 to $85,000 for 2006 and $80,000 to $100,000 for years after 2006; and (3) for married taxpayers filing separate returns, $0 to $10,000. If an individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the deduction is phased out for taxpayers with adjusted gross income between $150,000 and $160,000.

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to a traditional IRA, subject to the same limits as deductible contributions. An indi-

---

[603] Sec. 408.

[604] Sec. 219.

[605] Sec. 408A.

[606] Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the dollar limit on IRA contributions increases to $5,000 in 2008, with indexing for inflation thereafter. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010. As a result, the dollar limit on annual IRA contributions is $2,000 for years after 2010, and catch-ups contributions are not permitted.

vidual who has attained age 50 before the end of the taxable year may also make nondeductible catch-up contributions to an IRA.

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent the withdrawal is a return of nondeductible contributions. Withdrawals from an IRA before age 70½, death, or disability are subject to an additional 10-percent tax unless an exception applies.[607]

*Roth IRAs*

Individuals with adjusted gross income below certain levels may make nondeductible contributions to a Roth IRA, subject to the overall limit on IRA contributions described above. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with adjusted gross income over certain levels for the taxable year. The adjusted gross income phase-out ranges are: (1) for single taxpayers, $95,000 to $110,000; (2) for married taxpayers filing joint returns, $150,000 to $160,000; and (3) for married taxpayers filing separate returns, $0 to $10,000.

Taxpayers generally may convert a traditional IRA into a Roth IRA, except for married taxpayers filing separate returns. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings. The amount includible in income is also subject to the 10-percent early withdrawal tax described above.

### *Explanation of Provision*

The provision indexes the income limits applicable to the saver's credit beginning in 2007. (Another provision of the Act, described above, permanently extends the saver's credit.) Indexed amounts are rounded to the nearest multiple of $500. Under the indexed income limits, as under present law, the income limits for single taxpayers is one-half that for married taxpayers filing a joint return and the limits for heads of household are three-fourths that for married taxpayers filing a joint return.

The provision also indexes the income limits for IRA contributions beginning in 2007. The indexing applies to the income limits for deductible contributions for active participants in an employer-sponsored plan,[608] the income limits for deductible contributions if the individual is not an active participant but the individual's

[607] Sec. 72(t).

[608] Under the provision, for 2007, the lower end of the income phase out for active participants filing a joint return is $80,000 as adjusted to reflect inflation.

spouse is, and the income limits for Roth IRA contributions. Indexed amounts are rounded to the nearest multiple of $1,000. The provision does not affect the phase-out ranges under present law. Thus, for example, in the case of an active participant in an employer-sponsored plan, the phase-out range is $20,000 in the case of a married taxpayer filing a joint return and $10,000 in the case of an individual taxpayer.

### *Effective Date*

The provision is effective for taxable years beginning after December 31, 2006.

## D. Health and Medical Benefits

### 1. Ability to use excess pension assets for future retiree health benefits and collectively bargained retiree health benefits (sec. 841 of the Act and sec. 420 of the Code)

### *Present Law*

#### *Transfer of pension assets*

Defined benefit plan assets generally may not revert to an employer prior to termination of the plan and satisfaction of all plan liabilities. In addition, a reversion may occur only if the plan so provides. A reversion prior to plan termination may constitute a prohibited transaction and may result in plan disqualification. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax. The excise tax rate is 20 percent if the employer maintains a replacement plan or makes certain benefit increases in connection with the termination; if not, the excise tax rate is 50 percent. Upon plan termination, the accrued benefits of all plan participants are required to be 100 percent vested.

A pension plan may provide medical benefits to retired employees through a separate account that is part of such plan ("retiree medical accounts"). A qualified transfer of excess assets of a defined benefit plan to such a separate account within the plan may be made in order to fund retiree health benefits.[609] A qualified transfer does not result in plan disqualification, is not a prohibited transaction, and is not treated as a reversion. Thus, transferred assets are not includible in the gross income of the employer and are not subject to the excise tax on reversions. No more than one qualified transfer may be made in any taxable year. A qualified transfer may not be made from a multiemployer plan. No qualified transfer may be made after December 31, 2013.

Excess assets generally means the excess, if any, of the value of the plan's assets[610] over the greater of (1) the accrued liability under the plan (including normal cost) or (2) 125 percent of the plan's current liability.[611] In addition, excess assets transferred in

[609] Sec. 420.

[610] The value of plan assets for this purpose is the lesser of fair market value or actuarial value.

[611] In the case of plan years beginning before January 1, 2004, excess assets generally means the excess, if any, of the value of the plan's assets over the greater of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 170 percent of the plan's current

a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No deduction is allowed to the employer for (1) a qualified transfer or (2) the payment of qualified current retiree health liabilities out of transferred funds (and any income thereon). In addition, no deduction is allowed for amounts paid other than from transferred funds for qualified current retiree health liabilities to the extent such amounts are not greater than the excess of (1) the amount transferred (and any income thereon), over (2) qualified current retiree health liabilities paid out of transferred assets (and any income thereon). An employer may not contribute any amount to a health benefits account or welfare benefit fund with respect to qualified current retiree health liabilities for which transferred assets are required to be used.

Transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities for the taxable year of the transfer. Transferred amounts generally must benefit pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the separate account. Retiree health benefits of key employees may not be paid out of transferred assets.

Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20-percent excise tax.

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100 percent vested as if the plan terminated immediately before the transfer (or in the case of a participant who separated in the one-year period ending on the date of the transfer, immediately before the separation).

In order to a transfer to be qualified, the employer generally must maintain retiree health benefits at the same level for the taxable year of the transfer and the following four years.

In addition, ERISA provides that, at least 60 days before the date of a qualified transfer, the employer must notify the Secretary of Labor, the Secretary of the Treasury, employee representatives, and the plan administrator of the transfer, and the plan administrator must notify each plan participant and beneficiary of the transfer.[612]

### *Deductions for contributions*

Deductions for contributions to qualified retirement plans are subject to certain limits. Deductions for contributions to funded welfare benefit plans are generally also subject to limits, including limits on the amount that may be contributed to an account to fund the expected cost of retiree medical benefits for future years. The limit on the amount that may be contributed to an account to fund

---

liability (for 2003), or (2) 125 percent of the plan's current liability. The current liability full funding limit was repealed for years beginning after 2003. Under the general sunset provision of EGTRRA, the limit is reinstated for years after 2010.

[612] ERISA sec. 101(e). ERISA also provides that a qualified transfer is not a prohibited transaction under ERISA or a prohibited reversion.

the expected cost of retiree medical benefits for future years does not apply to a separate fund established under a collective bargaining agreement.

### *Explanation of Provision*

#### *In general*

If certain requirements are satisfied, the provision permits transfers of excess pension assets under a single-employer plan to retiree medical accounts to fund the expected cost of retiree medical benefits for the current and future years (a "qualified future transfer") and also allows such transfers in the case of benefits provided under a collective bargaining agreement (a "collectively bargained transfer"). Transfers must be made for at least a two-year period. An employer can elect to make a qualified future transfer or a collectively bargained transfer rather than a qualified transfer. A qualified future transfer or collectively bargained transfer must meet the requirements applicable to qualified transfers, except that the provision modifies the rules relating to (1) the determination of excess pension assets; (2) the limitation on the amount transferred; and (3) the minimum cost requirement. Additional requirements apply in the case of collectively bargained transfer.

The general sunset applicable to qualified transfer applies (i.e., transfers can be made only before January 1, 2014).

#### *Rule applicable to qualified future transfers and collectively bargained transfers*

Qualified future transfers and collectively bargained transfers can be made to the extent that plan assets exceed the greater of (1) accrued liability, or (2) 120 percent of current liability.[613] The provision requires that, during the transfer period, the plan's funded status must be maintained at the minimum level required to make transfers. If the minimum level is not maintained, the employer must make contributions to the plan to meet the minimum level or an amount required to meet the minimum level must be transferred from the health benefits account. The transfer period is the period not to exceed a total of ten consecutive taxable years beginning with the taxable year of the transfer. As previously discussed, the period must be not less than two consecutive years.

A limit applies on the amount that can be transferred. In the case of a qualified future transfer, the amount of excess pension assets that may be transferred is limited to the sum of (1) the amount that is reasonably estimated to be the amount the employer will pay out of the account during the taxable year of the transfer for current retiree health liabilities, and (2) the sum of the qualified current retiree health liabilities which the plan reasonably estimates, in accordance with guidance issued by the Secretary, will be incurred for each additional year in the transfer period. The amount that can be transferred under a collectively bargained transfer cannot exceed the amount which is reasonably estimated, in accordance with the provisions of the collective bargaining agreement and generally accepted accounting principles, to

[613] The single-employer plan funding concepts are updated after 2007 to reflect the changes to the single-employer plan funding rules under the Act.

be the amount the employer maintaining the plan will pay out of such account during the collectively bargained cost maintenance period for collectively bargained retiree health liabilities.

The provision also modifies the minimum cost requirement which requires retiree medical benefits to be maintained at a certain level. In the case of a qualified future transfer, the minimum cost requirement will be satisfied if, during the transfer period and the four subsequent years, the annual average amount of employer costs is not less than applicable employer cost determined with respect to the transfer. An employer may elect to meet this minimum cost requirement by meeting the requirements as in effect before the amendments made by section 535 of the Tax Relief Extension Act of 1999 for each year during the transfer period and the four subsequent years. In the case of a collectively bargained transfer, the minimum cost requirements is satisfied if each collectively bargained group health plan under which collectively bargained health benefits are provided provides that the collectively bargained employer cost for each taxable year during the collectively bargained cost maintenance period is not less than the amount specified by the collective bargaining agreement. The collectively bargained employer cost is the average cost per covered individual of providing collectively bargained retiree health benefits as determined in accordance with the applicable collective bargaining agreement. Thus, retiree medical benefits must be provided at the level determined under the collective bargaining agreement for the shorter of (1) the remaining lifetime of each covered retiree (and any covered spouse and dependent), or (2) the period of coverage provided under the collectively bargained health plan for such covered retiree (and any covered spouse and dependent).

***Additional requirements for collectively bargained transfers***

As previously discussed, the provision imposes certain additional requirements in the case of a collectively bargained transfer. Collectively bargained transfers can be made only if (1) for the employer's taxable year ending in 2005, medical benefits are provided to retirees (and spouses and dependents) under all the employer's benefit plans, and (2) the aggregate cost of benefits for such year is at least five percent of the employer's gross receipts. The provision also applies to successors of such employers. Before a collectively bargained transfer, the employer must designate in writing to each employee organization that is a party to the collective bargaining agreement that the transfer is a collectively bargained transfer.

Collectively bargained retiree health liabilities means the present value, as of the beginning of a taxable year and determined in accordance with the applicable collective bargaining agreement, of all collectively bargained health benefits (including administrative expenses) for such taxable year and all subsequent taxable years during the collectively bargained cost maintenance period (with the exclusion of certain key employees) reduced by the value of assets in all health benefits accounts or welfare benefit funds set aside to pay for the collectively bargained retiree health liabilities. Collectively bargained health benefits are health benefits or coverage provided to retired employees who, immediately before the collec-

tively bargained transfer, are entitled to receive such benefits upon retirement and who are entitled to pension benefits under the plan (and their spouses and dependents). If specified by the provisions of the collective bargaining agreement, collectively bargained health benefits also include active employees who, following their retirement, are entitled to receive such benefits and who are entitled to pension benefits under the plan (and their spouse and dependents).

Assets transferred in a collectively bargained transfer can be used to pay collectively bargained retiree health liabilities (other than liabilities of certain key employees not taken into account) for the taxable year of the transfer and for any subsequent taxable year during the collectively bargained cost maintenance period. The collectively bargained cost maintenance period (with respect to a retiree) is the shorter of (1) the remaining lifetime of the covered retiree (and any covered spouse and dependents) or (2) the period of coverage provided by the collectively bargained health plan with respect to such covered retiree (and any covered spouse and dependents).

The limit on deductions in the case of certain amounts paid for qualified current retiree health liabilities other than from the health benefits account does not apply in the case of a collectively bargained transfer.

An employer may contribute additional amounts to a health benefits account or welfare benefit fund with respect to collectively bargained health liabilities for which transferred assets are required to be used. The deductibility of such contributions are subject to the limits that otherwise apply to a welfare benefit fund under a collective bargaining agreements without regard to whether such contributions are made to a health benefits account or a welfare benefit fund and without regard to the limits on deductions for contributions to qualified retirement plans (under Code section 404). The Secretary of the Treasury is directed to provide rules to prevent duplicate deductions for the same contributions or for duplicate contributions to fund the same benefits.

### *Effective Date*

The provision is effective for transfers after the date of enactment (August 17, 2006).

## 2. Transfer of excess pension assets to multiemployer health plans (sec. 842 of the Act and sec. 420 of the Code)

### *Present Law*

Defined benefit plan assets generally may not revert to an employer prior to termination of the plan and satisfaction of all plan liabilities. In addition, a reversion may occur only if the plan so provides. A reversion prior to plan termination may constitute a prohibited transaction and may result in plan disqualification. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax. The excise tax rate is 20 percent if the employer maintains a replacement plan or makes certain benefit increases in connection with the termination; if not, the excise tax rate is 50 per-

cent. Upon plan termination, the accrued benefits of all plan participants are required to be 100 percent vested.

A pension plan may provide medical benefits to retired employees through a separate account that is part of such plan. A qualified transfer of excess assets of a defined benefit plan to such a separate account within the plan may be made in order to fund retiree health benefits.[614] A qualified transfer does not result in plan disqualification, is not a prohibited transaction, and is not treated as a reversion. Thus, transferred assets are not includible in the gross income of the employer and are not subject to the excise tax on reversions. No more than one qualified transfer may be made in any taxable year. A qualified transfer may not be made from a multiemployer plan. No qualified transfer may be made after December 31, 2013.

Excess assets generally means the excess, if any, of the value of the plan's assets[615] over the greater of (1) the accrued liability under the plan (including normal cost) or (2) 125 percent of the plan's current liability.[616] In addition, excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No deduction is allowed to the employer for (1) a qualified transfer or (2) the payment of qualified current retiree health liabilities out of transferred funds (and any income thereon).

Transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities for the taxable year of the transfer. Transferred amounts generally must benefit pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the separate account. Retiree health benefits of key employees may not be paid out of transferred assets.

Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20-percent excise tax.

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100-percent vested as if the plan terminated immediately before the transfer (or in the case of a participant who separated in the one-year period ending on the date of the transfer, immediately before the separation).

In order to a transfer to be qualified, the employer generally must maintain retiree health benefits at the same level for the taxable year of the transfer and the following four years.

In addition, ERISA provides that, at least 60 days before the date of a qualified transfer, the employer must notify the Secretary

---

[614] Sec. 420.

[615] The value of plan assets for this purpose is the lesser of fair market value or actuarial value.

[616] In the case of plan years beginning before January 1, 2004, excess assets generally means the excess, if any, of the value of the plan's assets over the greater of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 170 percent of the plan's current liability (for 2003), or (2) 125 percent of the plan's current liability. The current liability full funding limit was repealed for years beginning after 2003. Under the general sunset provision of EGTRRA, the limit is reinstated for years after 2010.

of Labor, the Secretary of the Treasury, employee representatives, and the plan administrator of the transfer, and the plan administrator must notify each plan participant and beneficiary of the transfer.[617]

Under present law, special deduction rules apply to a multiemployer defined benefit plan established before January 1, 1954, under an agreement between the Federal government and employee representatives in a certain industry.[618]

### *Explanation of Provision*

The provision allows qualified transfers of excess defined benefit plan assets to be made by multiemployer defined benefit plans.

### *Effective Date*

The provision is effective for transfer made in taxable years beginning after December 31, 2006.

## 3. Allowance of reserve for medical benefits of plans sponsored by bona fide associations (sec. 843 of the Act and sec. 419A of the Code)

### *Present Law*

Under present law, deductions for contributions to funded welfare benefit plans are generally subject to limits, including limits on the amount that may be contributed to an account to fund medical benefits (other than retiree medical benefits) for future years. Deductions for contributions to a welfare benefit fund are limited to the fund's qualified cost for the taxable year. The qualified cost is the sum of (1) the qualified direct cost for the taxable year, and (2) permissible additions to a qualified asset account.

The qualified direct costs are the amount which would have been allowable as a deduction to the employer with respect to the benefits provided during the taxable year if the benefits were provided directly by the employer and the employer used the cash receipts and disbursements method of accounting. Additions to the qualified asset account are limited to the account limit. The account limit is the amount reasonably and actuarially necessary to fund claims uncured but unpaid (as of the close of the taxable year) and administrative costs with respect to such claims.

These limits do not apply to a welfare benefit fund that is part of a plan (referred to a "10-or-more employer" plan), to which (1) more than one employer contributes, and (2) no employer normally contributes more than 10 percent of the total contributions, provided that the plan may not maintain experience rating arrangements with respect to individual employers.

### *Explanation of Provision*

The provision allows deductions for contributions to fund a reserve for medical benefits (other than retiree medical benefits) for future years provided through a bona fide association as defined in

[617] ERISA sec. 101(e). ERISA also provides that a qualified transfer is not a prohibited transaction under ERISA or a prohibited reversion.

[618] Code sec. 404(c).

section 2791(d)(3) of the Public Health Service Act. In such case, the account limit may include a reserve not to exceed 35 percent of the sum of (1) qualified direct costs, and (2) the change in claims incurred, but unpaid for such taxable year with respect to medical benefits (other than post-retirement medical benefits).

### *Effective Date*

The provision is effective for taxable years ending after December 31, 2006.

## 4. Tax treatment of combined annuity or life insurance contracts with a long-term care insurance feature (sec. 844 of the Act, secs. 72, 1035 and 7702B and new sec. 6050U of the Code)

### *Present Law*

#### *Annuity contracts*

In general, earnings and gains on amounts invested in a deferred annuity contract held by an individual are not subject to tax during the deferral period in the hands of the holder of the contract. When payout commences under a deferred annuity contract, the tax treatment of amounts distributed depends on whether the amount is received "as an annuity" (generally, as periodic payments under contract terms) or not.

For amounts received as an annuity by an individual, an "exclusion ratio" is provided for determining the taxable portion of each payment (sec. 72(b)). The portion of each payment that is attributable to recovery of the taxpayer's investment in the contract is not taxed. The taxable portion of each payment is ordinary income. The exclusion ratio is the ratio of the taxpayer's investment in the contract to the expected return under the contract, that is, the total of the payments expected to be received under the contract. The ratio is determined as of the taxpayer's annuity starting date. Once the taxpayer has recovered his or her investment in the contract, all further payments are included in income. If the taxpayer dies before the full investment in the contract is recovered, a deduction is allowed on the final return for the remaining investment in the contract (sec. 72(b)(3)).

Amounts not received as an annuity generally are included as ordinary income if received on or after the annuity starting date. Amounts not received as an annuity are included in income to the extent allocable to income on the contract if received before the annuity starting date, i.e., as income first (sec. 72(e)(2)). In general, loans under the annuity contract, partial withdrawals and partial surrenders are treated as amounts not received as an annuity and are subject to tax as income first (sec. 72(e)(4)). Exceptions are provided in some circumstances, such as for certain grandfathered contracts, certain life insurance and endowment contracts (other than modified endowment contracts), and contracts under qualified plans (sec. 72(e)(5)). Under these exceptions, the amount received is included in income, but only to the extent it exceeds the investment in the contract, i.e., as basis recovery first.

***Long-term care insurance contracts***

*Tax treatment*

Present law provides favorable tax treatment for qualified long-term care insurance contracts meeting the requirements of section 7702B.

A qualified long-term care insurance contract is treated as an accident and health insurance contract (sec. 7702B(a)(1)). Amounts received under the contract generally are excludable from income as amounts received for personal injuries or sickness (sec. 104(a)(3)). The excludable amount is subject to a dollar cap of $250 per day or $91,250 annually (for 2006), as indexed, on per diem contracts only (sec. 7702B(d)). If payments under such contracts exceed the dollar cap, then the excess is excludable only to the extent of costs in excess of the dollar cap that are incurred for long-term care services. Amounts in excess of the dollar cap, with respect to which no actual costs were incurred for long-term care services, are fully includable in income without regard to the rules relating to return of basis under section 72.

A plan of an employer providing coverage under a long-term care insurance contract generally is treated as an accident and health plan (benefits under which generally are excludable from the recipient's income under section 105).

Premiums paid for a qualified long-term care insurance contract are deductible as medical expenses, subject to a dollar cap on the deductible amount of the premium per year based on the insured person's age at the end of the taxable year (sec. 213(d)(10)). Medical expenses generally are allowed as a deduction only to the extent they exceed 7.5 percent of adjusted gross income (sec. 213(a)).

Unreimbursed expenses for qualified long-term care services provided to the taxpayer or the taxpayer's spouse or dependent are treated as medical expenses for purposes of the itemized deduction for medical expenses (subject to the floor of 7.5 percent of adjusted gross income). Amounts received under a qualified long-term care insurance contract (regardless of whether the contract reimburses expenses or pays benefits on a per diem or other periodic basis) are treated as reimbursement for expense actually incurred for medical care (sec. 7702B(a)(2)).

*Definitions*

A qualified long-term care insurance contract is defined as any insurance contract that provides only coverage of qualified long-term care services, and that meets additional requirements (sec. 7702B(b)). The contract is not permitted to provide for a cash surrender value or other money that can paid, assigned or pledged as collateral for a loan, or borrowed (and premium refunds are to be applied as a reduction in future premiums or to increase future benefits). Per diem-type and reimbursement-type contracts are permitted.

Qualified long-term care services are necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and maintenance or personal care services that are required by a chronically ill individual and that are provided pursu-

ant to a plan of care prescribed by a licensed health care practitioner (sec. 7702B(c)(1)).

A chronically ill individual is generally one who has been certified within the previous 12 months by a licensed health care practitioner as being unable to perform (without substantial assistance) at least 2 activities of daily (ADLs) for at least 90 days due to a loss of functional capacity (or meeting other definitional requirements) (sec. 7702B(c)(2)).

*Long-term care riders on life insurance contracts*

In the case of long-term care insurance coverage provided by a rider on or as part of a life insurance contract, the requirements applicable to long-term care insurance contracts apply as if the portion of the contract providing such coverage were a separate contract (sec. 7702B(e)). The term "portion" means only the terms and benefits that are in addition to the terms and benefits under the life insurance contract without regard to long-term care coverage. As a result, if the applicable requirements are met by the long-term care portion of the contract, amounts received under the contract as provided by the rider are treated in the same manner as long-term care insurance benefits, whether or not the payment of such amounts causes a reduction in the contract's death benefit or cash surrender value.

The guideline premium limitation applicable under section 7702(c)(2) is increased by the sum of charges (but not premium payments) against the life insurance contract's cash surrender value, less any such charges the imposition of which reduces premiums paid for the contract (within the meaning of sec. 7702(f)(1)). Thus, a policyholder can pre-fund to a greater degree a life insurance policy with a long-term care rider without causing the policy to lose its tax-favored treatment as life insurance.

No medical expense deduction generally is allowed under section 213 for charges against the life insurance contract's cash surrender value, unless such charges are includible in income because the life insurance contract is treated as a "modified endowment contract" under section 72(e)(10) and 7702A (sec. 7702B(e)((3)).

***Tax-free exchanges of insurance contracts***

Present law provides for the exchange of certain insurance contracts without recognition of gain or loss (sec. 1035). No gain or loss is recognized on the exchange of: (1) a life insurance contract for another life insurance contract or for an endowment or annuity contract; or (2) an endowment contract for another endowment contract (that provides for regular payments beginning no later than under the exchanged contract) or for an annuity contract; or (3) an annuity contract for an annuity contract. The basis of the contract received in the exchange generally is the same as the basis of the contract exchanged (sec. 1031(d)). Tax-free exchanges of long-term care insurance contracts are not permitted.

***Capitalization of certain policy acquisition expenses of insurance companies***

In the case of an insurance company, specified policy acquisition expenses for any taxable year are required to be capitalized, and

are amortized generally over the 120–month period beginning with the first month in the second half of the taxable year (sec. 848). Specified policy acquisition expenses are determined as that portion of the insurance company's general deductions for the taxable year that does not exceed a specific percentage of the net premiums for the taxable year on each of three categories of insurance contracts. For annuity contracts, the percentage is 1.75; for group life insurance contracts, the percentage is 2.05; and for all other specified insurance contracts, the percentage is 7.7. With certain exceptions, a specified insurance contract is any life insurance, annuity, or noncancellable accident and health insurance contract or combination thereof.

### *Explanation of Provision*

The provision provides tax rules for long-term care insurance that is provided by a rider on or as part of an annuity contract, and modifies the tax rules for long-term care insurance coverage provided by a rider on or as part of a life insurance contract.

Under the provision, any charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract made as payment for coverage under a qualified long- term care insurance contract that is part of or a rider on the annuity or life insurance contract is not includable in income. The investment in the contract is reduced (but not below zero) by the charge.

The provision expands the rules for tax-free exchanges of certain insurance contracts. The provision provides that no gain or loss is recognized on the exchange of a life insurance contract, an endowment contract, an annuity contract, or a qualified long-term care insurance contract for a qualified long-term care insurance contract. The provision provides that a contract does not fail to be treated as an annuity contract, or as a life insurance contract, solely because a qualified long-term care insurance contract is a part of or a rider on such contract, for purposes of the rules for tax-free exchanges of certain insurance contracts.

The provision provides that, except as otherwise provided in regulations, for Federal tax purposes, in the case of a long-term care insurance contract (whether or not qualified) provided by a rider on or as part of a life insurance contract or an annuity contract, the portion of the contract providing long-term care insurance coverage is treated as a separate contract. The term "portion" means only the terms and benefits under a life insurance contract or annuity contract that are in addition to the terms and benefits under the contract without regard to long-term care coverage. As a result, if the applicable requirements are met by the long-term care portion of the contract, amounts received under the contract as provided by the rider are treated in the same manner as long-term care insurance benefits, whether or not the payment of such amounts causes a reduction in the life insurance contract's death benefit or cash surrender value or in the annuity contract's cash value.

No deduction as a medical expense is allowed for any payment made for coverage under a qualified long-term care insurance contract if the payment is made as a charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract.

The provision provides that, for taxable years beginning after December 31, 2009, the guideline premium limitation is not directly increased by charges against a life insurance contract's cash surrender value for coverage under the qualified long-term care insurance portion of the contract. Rather, because such charges are not included in the holder's income by reason of new section 72(e)(11),[619] the charges reduce premiums paid under section 7702(f)(1), for purposes of the guideline premium limitation of section 7702. The amount by which premiums paid (under 7702(f)(1)) are reduced under this rule is intended to be the sum of any charges (but not premium payments) against the life insurance contract's cash surrender value (within the meaning of section 7702(f)(2)(a)) for long-term care coverage made to that date under the contract. For taxable years beginning before January 1, 2010, the present-law rule of section 7702B(e)(2) before amendment by the Act (the so-called "pay-as-you-go" rule) increases the guideline premium limitation by this same amount, reduced by charges the imposition of which reduces the premiums paid under the contract. Thus, the provision of the Act recreates the result of the "pay-as-you-go" rule (which is repealed by the provision) as a reduction in premiums paid rather than as an increase in the guideline premium limitation.

The provision provides that certain retirement-related arrangements are not treated as annuity contracts, for purposes of the provision.

The provision requires information reporting by any person who makes a charge against the cash value of an annuity contract, or the cash surrender value of a life insurance contract, that is excludible from gross income under the provision. The information required to be reported includes the amount of the aggregate of such charges against each such contract for the calendar year, the amount of the reduction in the investment in the contract by reason of the charges, and the name, address, and taxpayer identification number of the holder of the contract. A statement is required to be furnished to each individual identified in the information report. Penalties apply for failure to file the information report or furnish the statement required under the provision.

The provision modifies the application of the rules relating to capitalization of policy acquisition expenses of insurance companies. In the case of an annuity or life insurance contract that includes a qualified long-term care insurance contract as a part of or rider on the annuity or life insurance contract, the specified policy acquisition expenses that must be capitalized is determined using 7.7 percent of the net premiums for the taxable year on such contracts.

The provision clarifies that, effective as if included in the Health Insurance Portability and Accountability Act of 1996 (when section 7702B was enacted), except as otherwise provided in regulations, for Federal tax purposes (not just for purposes of section 7702B),

[619] Because such charges are not included in the holder's income under new section 72(e)(11), the effect would be to increase the guideline premium limitation under present-law section 7702B(e)(2)(A) by the amount of the charges and simultaneously to reduce it by the same charges under section 7702B(e)(2)(B). Such charges that are not included in income serve to reduce premiums paid under section 7702(f)(1), and therefore would cancel each other out under 7702B(e)(2)(A) and (B).

in the case of a long-term care insurance contract (whether or not qualified) provided by a rider on or as part of a life insurance contract, the portion of the contract providing long-term care insurance coverage is treated as a separate contract.

### *Effective Date*

The provisions are effective generally for contracts issued after December 31, 1996, but only with respect to taxable years beginning after December 31, 2009. The provisions relating to tax-free exchanges apply with respect to exchanges occurring after December 31, 2009. The provision relating to information reporting applies to charges made after December 31, 2009. The provision relating to policy acquisition expenses applies to specified policy acquisition expenses determined for taxable years beginning after December 31, 2009. The technical amendment relating to long-term care insurance coverage under section 7702B(e) is effective as if included with the underlying provisions of the Health Insurance Portability and Accountability Act of 1996.

## 5. Permit tax-free distributions from governmental retirement plans for premiums for health and long-term care insurance for public safety officers (sec. 845 of the Act and sec. 402 of the Code)

### *Present Law*

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 (except to the extent the amount received constitutes a return of after-tax contributions or a qualified distribution from a Roth IRA).[620] In addition, a distribution from a qualified retirement or annuity plan, a 403(b) annuity, or an IRA received before age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception applies.[621]

### *Explanation of Provision*

The provision provides that certain pension distributions from an eligible retirement plan used to pay for qualified health insurance premiums are excludible from income, up to a maximum exclusion of $3,000 annually. An eligible retirement plan includes a governmental qualified retirement or annuity plan, 403(b) annuity, or 457 plan. The exclusion applies with respect to eligible retired public safety officers who make an election to have qualified health insurance premiums deducted from amounts distributed from an eligible retirement plan and paid directly to the insurer. An eligible retired public safety officer is an individual who, by reason of disability or

[620] Secs. 402(a), 403(a), 403(b), 408(d), and 457(a).
[621] Sec. 72(t).

attainment of normal retirement age, is separated from service as a public safety officer[622] with the employer who maintains the eligible retirement plan from which pension distributions are made.

Qualified health insurance premiums include premiums for accident or health insurance or qualified long-term care insurance contracts covering the taxpayer, the taxpayer's spouse, and the taxpayer's dependents. The qualified health insurance premiums do not have to be for a plan sponsored by the employer; however, the exclusion does not apply to premiums paid by the employee and reimbursed with pension distributions. Amounts excluded from income under the provision are not taken into account in determining the itemized deduction for medical expenses under section 213 or the deduction for health insurance of self-employed individuals under section 162.

### *Effective Date*

The provision is effective for distributions in taxable years beginning after December 31, 2006.

## E. United States Tax Court Modernization

### 1. Judges of the Tax Court (secs. 851, 852 and 853 of the Act and secs. 7447, 7448 and 7472 of the Code)

### *Present Law*

The Tax Court is established by the Congress pursuant to Article I of the U.S. Constitution.[623] The salary of a Tax Court judge is the same salary as received by a U.S. District Court judge.[624] Present law also provides Tax Court judges with some benefits that correspond to benefits provided to U.S. District Court judges, including specific retirement and survivor benefit programs for Tax Court judges.[625]

Under the retirement program, a Tax Court judge may elect to receive retirement pay from the Tax Court in lieu of benefits under another Federal retirement program. A Tax Court judge may also elect to participate in a plan providing annuity benefits for the judge's surviving spouse and dependent children (the "survivors" annuity plan"). Generally, benefits under the survivors" annuity plan are payable only if the judge has performed at least five years of service. Cost-of-living increases in benefits under the survivors' annuity plan are generally based on increases in pay for active judges.

Tax Court judges participate in the Federal Employees Group Life Insurance program (the "FEGLI" program). Retired Tax Court judges are eligible to participate in the FEGLI program as the result of an administrative determination of their eligibility, rather than a specific statutory provision.

Tax Court judges are not eligible to participate in the Thrift Savings Plan.

---

[622] The term "public safety officer" has the same meaning as under section 1204(9)(A) of the Omnibus Crime Control and Safe Streets Act of 1986.

[623] Sec. 7441.

[624] Sec. 7443(c).

[625] Secs. 7447 and 7448.

### *Explanation of Provision*

#### *Cost-of-living adjustments for survivor annuities*

The provision provides that cost-of-living increases in benefits under the survivors' annuity plan are generally based on cost-of-living increases in benefits paid under the Civil Service Retirement System.

#### *Life insurance coverage*

In the case of a Tax Court judge age 65 or over, the Tax Court is authorized to pay on behalf of the judge any increase in employee premiums under the FEGLI program that occur after the date of enactment, including expenses generated by such payment, as authorized by the chief judge of the Tax Court in a manner consistent with payments authorized by the Judicial Conference of the United States (i.e., the body with policy-making authority over the administration of the courts of the Federal judicial branch).

#### *Thrift Savings Plan participation*

Under the provision, Tax Court judges are permitted to participate in the Thrift Savings Plan. A Tax Court judge is not eligible for agency contributions to the Thrift Savings Plan.

### *Effective Date*

The provisions are effective on the date of enactment (August 17, 2006), except that the provision relating to cost-of-living increases in benefits under the survivors' annuity plan applies with respect to increases in Civil Service Retirement benefits taking effect after the date of enactment.

## 2. Special trial judges of the Tax Court (secs. 854 and 856 of the Act, and sec. 7448 and new sec. 7443C of the Code)

### *Present Law*

The Tax Court is established by the Congress pursuant to Article I of the U.S. Constitution.[626] The chief judge of the Tax Court may appoint special trial judges to handle certain cases.[627] Special trial judges serve for an indefinite term. Special trial judges receive a salary of 90 percent of the salary of a Tax Court judge and are generally covered by the benefit programs that apply to Federal executive branch employees, including the Civil Service Retirement System or the Federal Employees' Retirement System.

### *Explanation of Provision*

#### *Survivors' annuity plan*

Under the provision, magistrate judges of the Tax Court may elect to participate in the survivors' annuity plan for Tax Court judges. An election to participate in the survivors' annuity plan must be filed not later than the latest of: (1) twelve months after

[626] Sec. 7441.
[627] Sec. 7443A.

the of the provision; (2) six months after the date the judge takes office; or (3) six months after the date the judge marries.

***Recall of retired special trial judges***

The provision provides rules under which a retired special trial judge may be recalled to perform services for up to 90 days a year.

### *Effective Date*

The provisions are effective on the date of enactment (August 17, 2006).

## 3. Consolidate review of collection due process cases in the Tax Court (sec. 855 of the Act and sec. 6330(d) of the Code)

### *Present Law*

In general, the IRS is required to notify taxpayers that they have a right to a fair and impartial hearing before levy may be made on any property or right to property.[628] Similar rules apply with respect to liens.[629] The hearing is held by an impartial officer from the IRS Office of Appeals, who is required to issue a determination with respect to the issues raised by the taxpayer at the hearing. The taxpayer is entitled to appeal that determination to a court. The appeal must be brought to the Tax Court, unless the Tax Court does not have jurisdiction over the underlying tax liability. If that is the case, then the appeal must be brought in the district court of the United States.[630] If a court determines that an appeal was not made to the correct court, the taxpayer has 30 days after such determination to file with the correct court.

The Tax Court is established under Article I of the United States Constitution[631] and is a court of limited jurisdiction.[632] The Tax Court only has the jurisdiction that is expressly conferred on it by statute.[633] For example, the jurisdiction of the Tax Court includes the authority to hear disputes concerning notices of income tax deficiency, certain types of declaratory judgment, and worker classification status, among others, but does not include jurisdiction over most excise taxes imposed by the Internal Revenue Code. Thus, the Tax Court may not have jurisdiction over the underlying tax liability with respect to an appeal of a due process hearing relating to a collections matter. As a practical matter, many cases involving appeals of a due process hearing (whether within the jurisdiction of the Tax Court or a district court) do not involve the underlying tax liability.

### *Explanation of Provision*

The provision modifies the jurisdiction of the Tax Court by providing that all appeals of collection due process determinations are to be made to the United States Tax Court.

---

[628] Sec. 6330(a).
[629] Sec. 6320.
[630] Sec. 6330(d).
[631] Sec. 7441.
[632] Sec. 7442.
[633] Sec. 7442.

### *Effective Date*

The provision applies to determinations made after the date which is 60 days after the date of enactment (August 17, 2006).

## 4. Extend authority for special trial judges to hear and decide certain employment status cases (sec. 857 of the Act and sec. 7443A of the Code)

### *Present Law*

In connection with the audit of any person, if there is an actual controversy involving a determination by the IRS as part of an examination that (1) one or more individuals performing services for that person are employees of that person or (2) that person is not entitled to relief under section 530 of the Revenue Act of 1978, the Tax Court has jurisdiction to determine whether the IRS is correct and the proper amount of employment tax under such determination.[634] Any redetermination by the Tax Court has the force and effect of a decision of the Tax Court and is reviewable.

An election may be made by the taxpayer for small case procedures if the amount of the employment taxes in dispute is $50,000 or less for each calendar quarter involved.[635] The decision entered under the small case procedure is not reviewable in any other court and should not be cited as authority.

The chief judge of the Tax Court may assign proceedings to special trial judges. The Code enumerates certain types of proceedings that may be so assigned and may be decided by a special trial judge. In addition, the chief judge may designate any other proceeding to be heard by a special trial judge.[636]

### *Explanation of Provision*

The provision clarifies that the chief judge of the Tax Court may assign to special trial judges any employment tax cases that are subject to the small case procedure and may authorize special trial judges to decide such small tax cases.

### *Effective Date*

The provision is effective for any action or proceeding in the Tax Court with respect to which a decision has not become final as of the date of enactment (August 17, 2006).

## 5. Confirmation of Tax Court authority to apply equitable recoupment (sec. 858 of the Act and sec. 6214(b) of the Code)

### *Present Law*

Equitable recoupment is a common-law equitable principle that permits the defensive use of an otherwise time-barred claim to reduce or defeat an opponent's claim if both claims arise from the same transaction. U.S. District Courts and the U.S. Court of Fed-

[634] Sec. 7436.
[635] Sec. 7436(c).
[636] Sec. 7443A.

eral Claims, the two Federal tax refund forums, may apply equitable recoupment in deciding tax refund cases.[637] In Estate of Mueller v. Commissioner,[638] the Court of Appeals for the Sixth Circuit held that the United States Tax Court (the "Tax Court") may not apply the doctrine of equitable recoupment. More recently, the Court of Appeals for the Ninth Circuit, in Branson v. Commissioner,[639] held that the Tax Court may apply the doctrine of equitable recoupment.

### *Explanation of Provision*

The provision confirms that the Tax Court may apply the principle of equitable recoupment to the same extent that it may be applied in Federal civil tax cases by the U.S. District Courts or the U.S. Court of Claims. No implication is intended as to whether the Tax Court has the authority to continue to apply other equitable principles in deciding matters over which it has jurisdiction.

### *Effective Date*

The provision is effective for any action or proceeding in the Tax Court with respect to which a decision has not become final as of the date of enactment (August 17, 2006).

## 6. Tax Court filing fee (sec. 859 of the Act and sec. 7451 of the Code)

### *Present Law*

The Tax Court is authorized to impose a fee of up to $60 for the filing of any petition for the redetermination of a deficiency or for declaratory judgments relating to the status and classification of 501(c)(3) organizations, the judicial review of final partnership administrative adjustments, and the judicial review of partnership items if an administrative adjustment request is not allowed in full.[640] The statute does not specifically authorize the Tax Court to impose a filing fee for the filing of a petition for review of the IRS's failure to abate interest or for failure to award administrative costs and other areas of jurisdiction for which a petition may be filed. The practice of the Tax Court is to impose a $60 filing fee in all cases commenced by petition.[641]

### *Explanation of Provision*

The provision provides that the Tax Court is authorized to charge a filing fee of up to $60 in all cases commenced by the filing of a petition. No negative inference is to be drawn as to whether the Tax Court has the authority under present law to impose a filing fee for any case commenced by the filing of a petition.

---

[637] *See Stone* v. *White*, 301 U.S. 532 (1937); *Bull* v. *United States*, 295 U.S. 247 (1935).
[638] 153 F.3d 302 (6th Cir.), *cert. den.*, 525 U.S. 1140 (1999).
[639] 264 F.3d 904 (9th Cir.), *cert. den.*, 2002 U.S. LEXIS 1545 (U.S. Mar. 18, 2002).
[640] Sec. 7451.
[641] *See* Rule 20(b) of the Tax Court Rules of Practice and Procedure.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

### 7. Use of practitioner fee (sec. 860 of the Act and sec. 7475(b) of the Code)

### *Present Law*

The Tax Court is authorized to impose a fee of up to $30 per year on practitioners admitted to practice before the Tax Court.[642] These fees are to be used to employ independent counsel to pursue disciplinary matters.

### *Explanation of Provision*

The provision provides that Tax Court fees imposed on practitioners also are available to provide services to pro se taxpayers (i.e., a taxpayer representing himself) that will assist such taxpayers in controversies before the Court. For example, fees could be used for programs to educate pro se taxpayers on the procedural requirements for contesting a tax deficiency before the Tax Court.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## F. Other Provisions

### 1. Extension to all governmental plans of moratorium on application of certain nondiscrimination rules (sec. 861 of the Act, sec. 1505 of the Taxpayer Relief Act of 1997, and secs. 401(a) and 401(k) of the Code)

### *Present Law*

A qualified retirement plan maintained by a State or local government is exempt from the nondiscrimination and minimum participation requirements. A cash or deferred arrangement maintained by a State or local government is also treated as meeting the participation and nondiscrimination requirements applicable to such a qualified cash or deferred arrangement. Other governmental plans are subject to these requirements.[643]

### *Explanation of Provision*

The provision exempts all governmental plans from the nondiscrimination and minimum participation rules. The provision also treats all governmental cash or deferred arrangements as meeting the participation and nondiscrimination requirements applicable to a qualified cash or deferred arrangement.

---

[642] Sec. 7475.

[643] The IRS has announced that governmental plans that are subject to the nondiscrimination requirements are deemed to satisfy such requirements pending the issuance of final regulations addressing this issue. Notice 2003–6, 2003–3 I.R.B. 298; Notice 2001–46, 2001–2 C.B. 122.

### *Effective Date*

The provision is effective for any year beginning after the date of enactment (August 17, 2006).

## 2. Eliminate aggregate limit for usage of excess funds from black lung disability trusts to pay for retiree health (sec. 862 of the Act and secs. 501(c)(21) and 9705 of the Code)

### *Present Law*

#### *Qualified black lung benefit trusts*

A qualified black lung benefit trust is exempt from Federal income taxation. Contributions to a qualified black lung benefit trust generally are deductible to the extent such contributions are necessary to fund the trust.

Under present law, no assets of a qualified black lung benefit trust may be used for, or diverted to, any purpose other than (1) to satisfy liabilities, or pay insurance premiums to cover liabilities, arising under the Black Lung Acts, (2) to pay administrative costs of operating the trust, (3) to pay accident and health benefits or premiums for insurance exclusively covering such benefits (including administrative and other incidental expenses relating to such benefits) for retired coal miners and their spouses and dependents (within certain limits) or (4) investment in Federal, State, or local securities and obligations, or in time demand deposits in a bank or insured credit union. Additionally, trust assets may be paid into the national Black Lung Disability Trust Fund, or into the general fund of the U.S. Treasury.

The amount of assets in qualified black lung benefit trusts available to pay accident and health benefits or premiums for insurance exclusively covering such benefits (including administrative and other incidental expenses relating to such benefits) for retired coal miners and their spouses and dependents may not exceed a yearly limit or an aggregate limit, whichever is less. The yearly limit is the amount of trust assets in excess of 110 percent of the present value of the liability for black lung benefits determined as of the close of the preceding taxable year of the trust. The aggregate limit is the excess of the sum of the yearly limit as of the close of the last taxable year ending before October 24, 1992, plus earnings thereon as of the close of the taxable year preceding the taxable year involved over the aggregate payments for accident of health benefits for retired coal miners and their spouses and dependents made from the trust since October 24, 1992. Each of these determinations is required to be made by an independent actuary.

In general, amounts used to pay retiree accident or health benefits are not includible in the income of the company, nor is a deduction allowed for such amounts.

#### *United Mine Workers of America Combined Benefit Fund*

The United Mine Workers of America ("UMWA") Combined Benefit Fund was established by the Coal Industry Retiree Health Benefit Act of 1992 to assume responsibility of payments for medical care expenses of retired miners and their dependents who were eligible for health care from the private 1950 and 1974 UMWA Ben-

efit Plans. The UMWA Combined Benefit Fund is financed by assessments on current and former signatories to labor agreements with the UMWA, past transfers from an overfunded United Mine Workers pension fund, and transfers from the Abandoned Mine Reclamation Fund.

### *Explanation of Provision*

The provision eliminates the aggregate limit on the amount of excess black lung benefit trust assets that may be used to pay accident and health benefits or premiums for insurance exclusively covering such benefits (including administrative and other incidental expenses relating to such benefits) for retired coal miners and their spouses and dependents.

### *Effective Date*

The provision is effective for taxable years beginning after December 31, 2006.

## 3. Tax treatment of death benefits from company-owned life insurance ("COLI") (sec. 863 of the Act and new secs. 101(j) and 6039I of the Code)

### *Present Law*

#### *Amounts received under a life insurance contract*

Amounts received under a life insurance contract paid by reason of the death of the insured are not includible in gross income for Federal tax purposes.[644] No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract (inside buildup).[645]

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income to the extent that the amounts distributed exceed the taxpayer's investment in the contract (i.e., basis). Such distributions generally are treated first as a tax-free recovery of basis, and then as income.[646]

---

[644] Sec. 101(a).

[645] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702).

[646] Sec. 72(e). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59½ and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

### *Premium and interest deduction limitations*[647]

*Premiums*

Under present law, no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.[648]

*Interest paid or accrued with respect to the contract*

No deduction generally is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual.[649] An exception is provided under this provision for insurance of key persons.

Interest that is otherwise deductible (e.g., is not disallowed under other applicable rules or general principles of tax law) may be deductible under the key person exception, to the extent that the aggregate amount of the debt does not exceed $50,000 per insured individual. The deductible interest may not exceed the amount determined by applying a rate based on a Moody's Corporate Bond Yield Average-Monthly Average Corporates. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) five individuals, or (2) the lesser of five percent of the total number of officers and employees of the taxpayer, or 20 individuals.[650]

*Pro rata interest limitation*

A pro rata interest deduction disallowance rule also applies. Under this rule, in the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values.[651] Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance, annuity and endowment contracts, to (2) the sum of the average unborrowed cash values (or average adjusted bases, for other assets) of all the taxpayer's assets.

Under the pro rata interest disallowance rule, an exception is provided for any contract owned by an entity engaged in a trade or business, if the contract covers an individual who is a 20-percent owner of the entity, or an officer, director, or employee of the trade or business. The exception also applies to a joint-life contract covering a 20-percent owner and his or her spouse.

---

[647] In addition to the statutory limitations described below, interest deductions under company-owned life insurance arrangements have also been limited by recent cases applying general principles of tax law. See *Winn-Dixie Stores, Inc.* v. *Commissioner*, 113 T.C. 254 (1999), aff'd 254 F.3d 1313 (11th Cir. 2001), cert. denied, April 15, 2002; *Internal Revenue Service* v. *CM Holdings, Inc.*, 254 B.R. 578 (D. Del. 2000), aff'd, 301 F.3d 96 (3d Cir. 2002); *American Electric Power, Inc.* v. U.S., 136 F. Supp. 2d 762 (S. D. Ohio 2001), aff'd, 326 F.3d 737 (6th Cir. 2003), reh. denied, 338 F.3d 534 (6th Cir. 2003), cert. denied, U.S. No. 03–529 (Jan. 12, 2004); *Dow Chemical Company* v. *U.S.*, 435 F.3d 594 (6th Cir. 2006), rev'g 250 F. Supp. 2d 748 (E.D. Mich. 2003) as modified, 278 F. Supp. 2d 844 (E.D. Mich. 2003).

[648] Sec. 264(a)(1).

[649] Sec. 264(a)(4).

[650] Sec. 264(e)(3).

[651] Sec. 264(f). This applies to any life insurance, annuity or endowment contract issued after June 8, 1997.

*"Single premium" and "4-out-of-7" limitations*

Other interest deduction limitation rules also apply with respect to life insurance, annuity and endowment contracts. Present law provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity or endowment contract.[652] In addition, present law provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise).[653] Under this rule, several exceptions are provided, including an exception if no part of four of the annual premiums due during the initial seven-year period is paid by means of such debt (known as the "4-out-of-7 rule").

***Definitions of highly compensated employee***

Present law defines highly compensated employees and individuals for various purposes. For purposes of nondiscrimination rules relating to qualified retirement plans, an employee, including a self-employed individual, is treated as highly compensated with respect to a year if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year or (2) either (a) had compensation for the preceding year in excess of $95,000 (for 2005) or (b) at the election of the employer had compensation in excess of $95,000 (for 2005) and was in the highest paid 20 percent of employees for such year.[654] The $95,000 dollar amount is indexed for inflation.

For purposes of nondiscrimination rules relating to self-insured medical reimbursement plans, a highly compensated individual is an employee who is one of the five highest paid officers of the employer, a shareholder who owns more than 10 percent of the value of the stock of the employer, or is among the highest paid 25 percent of all employees.[655]

## *Explanation of Provision*

The provision provides generally that, in the case of an employer-owned life insurance contract, the amount excluded from the applicable policyholder's income as a death benefit cannot exceed the premiums and other amounts paid by such applicable policyholder for the contract. The excess death benefit is included in income.

Exceptions to this income inclusion rule are provided. In the case of an employer-owned life insurance contract with respect to which the notice and consent requirements of the provision are met, the income inclusion rule does not apply to an amount received by reason of the death of an insured individual who, with respect to the applicable policyholder, was an employee at any time during the

[652] Sec. 264(a)(2).
[653] Sec. 264(a)(3).
[654] Sec. 414(q). For purposes of determining the top-paid 20 percent of employees, certain employees, such as employees subject to a collective bargaining agreement, are disregarded.
[655] Sec. 105(h)(5). For purposes of determining the top-paid 25 percent of employees, certain employees, such as employees subject to a collective bargaining agreement, are disregarded.

12-month period before the insured's death, or who, at the time the contract was issued, was a director or highly compensated employee or highly compensated individual. For this purpose, such a person is one who is either: (1) a highly compensated employee as defined under the rules relating to qualified retirement plans, determined without regard to the election regarding the top-paid 20 percent of employees; or (2) a highly compensated individual as defined under the rules relating to self-insured medical reimbursement plans, determined by substituting the highest-paid 35 percent of employees for the highest-paid 25 percent of employees.[656]

In the case of an employer-owned life insurance contract with respect to which the notice and consent requirements of the provision are met, the income inclusion rule does not apply to an amount received by reason of the death of an insured, to the extent the amount is (1) paid to a member of the family[657] of the insured, to an individual who is the designated beneficiary of the insured under the contract (other than an applicable policyholder), to a trust established for the benefit of any such member of the family or designated beneficiary, or to the estate of the insured; or (2) used to purchase an equity (or partnership capital or profits) interest in the applicable policyholder from such a family member, beneficiary, trust or estate. It is intended that such amounts be so paid or used by the due date of the tax return for the taxable year of the applicable policyholder in which they are received as a death benefit under the insurance contract, so that the payment of the amount to such a person or persons, or the use of the amount to make such a purchase, is known in the taxable year for which the exception from the income inclusion rule is claimed.

An employer-owned life insurance contract is defined for purposes of the provision as a life insurance contract which (1) is owned by a person engaged in a trade or business and under which such person (or a related person) is directly or indirectly a beneficiary, and (2) covers the life of an individual who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued.

An applicable policyholder means, with respect to an employer-owned life insurance contract, the person (including related persons) that owns the contract, if the person is engaged in a trade or business, and if the person (or a related person) is directly or indirectly a beneficiary under the contract.

For purposes of the provision, a related person includes any person that bears a relationship specified in section 267(b) or 707(b)(1)[658] or is engaged in trades or businesses that are under common control (within the meaning of section 52(a) or (b)).

---

[656] As under present law, certain employees are disregarded in making the determinations regarding the top-paid groups.

[657] For this purpose, a member of the family is defined in section 267(c)(4) to include only the individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

[658] The relationships include specified relationships among family members, shareholders and corporations, corporations that are members of a controlled group, trust grantors and fiduciaries, tax-exempt organizations and persons that control such organizations, commonly controlled S corporations, partnerships and C corporations, estates and beneficiaries, commonly controlled partnerships, and partners and partnerships. Detailed rules apply to determine the specific relationships.

The notice and consent requirements of the provision are met if, before the issuance of the contract, (1) the employee is notified in writing that the applicable policyholder intends to insure the employee's life, and is notified of the maximum face amount at issue of the life insurance contract that the employer might take out on the life of the employee, (2) the employee provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment, and (3) the employee is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable on the death of the employee.

For purposes of the provision, an employee includes an officer, a director, and a highly compensated employee; an insured means, with respect to an employer-owned life insurance contract, an individual covered by the contract who is a U.S. citizen or resident. In the case of a contract covering the joint lives of two individuals, references to an insured include both of the individuals.

The provision requires annual reporting and recordkeeping by applicable policyholders that own one or more employer-owned life insurance contracts. The information to be reported is (1) the number of employees of the applicable policyholder at the end of the year, (2) the number of employees insured under employer-owned life insurance contracts at the end of the year, (3) the total amount of insurance in force at the end of the year under such contracts, (4) the name, address, and taxpayer identification number of the applicable policyholder and the type of business in which it is engaged, and (5) a statement that the applicable policyholder has a valid consent (in accordance with the consent requirements under the provision) for each insured employee and, if all such consents were not obtained, the total number of insured employees for whom such consent was not obtained. The applicable policyholder is required to keep records necessary to determine whether the requirements of the reporting rule and the income inclusion rule of new section 101(j) are met.

### *Effective Date*

The provision generally applies to contracts issued after the date of enactment, except for contracts issued after such date pursuant to an exchange described in section 1035 of the Code. In addition, certain material increases in the death benefit or other material changes will generally cause a contract to be treated as a new contract, with an exception for existing lives under a master contract. Increases in the death benefit that occur as a result of the operation of section 7702 of the Code or the terms of the existing contract, provided that the insurer's consent to the increase is not required, will not cause a contract to be treated as a new contract. In addition, certain changes to a contract will not be considered material changes so as to cause a contract to be treated as a new contract. These changes include administrative changes, changes from general to separate account, or changes as a result of the exercise of an option or right granted under the contract as originally issued.

Examples of situations in which death benefit increases would not cause a contract to be treated as a new contract include the following:

1. Section 7702 provides that life insurance contracts need to either meet the cash value accumulation test of section 7702(b) or the guideline premium requirements of section 7702(c) and the cash value corridor of section 7702(d). Under the corridor test, the amount of the death benefit may not be less than the applicable percentage of the cash surrender value. Contracts may be written to comply with the corridor requirement by providing for automatic increases in the death benefit based on the cash surrender value. Death benefit increases required by the corridor test or the cash value accumulation test do not require the insurer's consent at the time of increase and occur in order to keep the contact in compliance with section 7702.

2. Death benefits may also increase due to normal operation of the contract. For example, for some contracts, policyholder dividends paid under the contract may be applied to purchase paid-up additions, which increase the death benefits. The insurer's consent is not required for these death benefit increases.

3. For variable contacts and universal life contracts, the death benefit may increase as a result of market performance or the contract design. For example, some contracts provide that the death benefit will equal the cash value plus a specified amount at risk. With these contracts, the amount of the death benefit at any time will vary depending on changes in the cash value of the contract. The insurance company's consent is not required for these death benefit increases.

### 4. Treatment of test room supervisors and proctors who assist in the administration of college entrance and placement exams (sec. 864 of the Act and sec. 530 of the Revenue Reconciliation Act of 1978)

#### *Present Law*

Section 530 of the Revenue Act of 1978 prohibits the Internal Revenue Service from challenging a taxpayer's treatment of an individual as an independent contractor for employment tax purposes if the taxpayer (1) has a reasonable basis for such treatment and (2) consistently treats the individual, and any other individual holding a substantially similar position, as an independent contractor.

#### *Explanation of Provision*

Under the provision, section 530 of the Revenue Act of 1978 is amended to provide that in the case of an individual providing services as a test proctor or room supervisor by assisting in the administration of college entrance or placements examinations, the consistency requirement does not apply with respect to services performed after December 31, 2006 (and remuneration paid with respect to such services). The provision applies if the individual (1) is performing the services for a tax-exempt organization, and (2) is not otherwise treated as an employee of such organization for purposes of employment taxes. Thus, under the provision, if the requirements are satisfied, the IRS is prohibited from challenging the treatment of such individuals as independent contractors for em-

ployment tax purposes, even if the organization previously treated such individuals as employees.

### *Effective Date*

The provision is effective for remuneration paid for services performed after December 31, 2006.

## 5. Rule for church plans which self-annuitize (sec. 865 of the Act and sec. 401(a)(9) of the Code)

### *Present Law*

Minimum distribution rules apply to qualified retirement plans (sec. 401(a)(9)). Special rules apply in the case of payments under an annuity contract purchased with the employee's benefit by the plan from an insurance company.[659] If certain requirements are satisfied, these special rules apply to annuity payments from a retirement income account maintained by a church (or certain other organizations as described in sec. 403(b)(9)) even though the payments are not made under an annuity purchased from an insurance company.[660]

### *Explanation of Provision*

The provision provides that annuity payments provided with respect to any account maintained for a participant or beneficiary under a qualified church plan does not fail to meet the minimum distribution rules merely because the payments are not made under an annuity contract purchased from an insurance company if such payments would not fail such requirements if provided with respect to a retirement income account described in section 403(b)(9).

For purposes of the provision, a qualified church plan means any money purchase plan described in section 401(a) which (1) is a church plan (as defined in section 414(e)) with respect to which the election provided by section 410(d) has not been made, and (2) was in existence on April 17, 2002.

### *Effective Date*

The provision is effective for years ending after the date of enactment (August 17, 2006). No inference is intended from the provision with respect to the proper application of the minimum distribution rules to church plans before the effective date.

## 6. Exemption for income from leveraged real estate held by church plans (sec. 866 of the Act and sec. 514(c)(9) of the Code)

### *Present Law*

Debt-financed income of a tax-exempt entity is subject to unrelated business income tax ("UBIT") under section 514 of the Code.

[659] Treas. Reg. sec. 1.401(a)(9)–6, A–4.
[660] Treas. Reg. sec. 1.403(b)–3, A–1(c)(3).

Debt-financed property generally is property that is held to produce income and with respect to which there is acquisition indebtedness.

There is an exception to the UBIT rules for debt-financed property held by qualifying organizations (sec. 514(c)(9)). Qualified organizations include retirement plans qualified under section 401(a).

### *Explanation of Provision*

The provision provides that a retirement income account of a church (or certain other organizations) as defined in section 403(b)(9) is a qualified organization for purposes of the exemption from the UBIT debt-financed property rules.

### *Effective Date*

The provision is effective for taxable years beginning on or after the date of enactment (August 17, 2006).

## 7. Church plan rule for benefit limitations (sec. 867 of the Act and sec. 415(b) of the Code)

### *Present Law*

Section 415 limits the amount of benefits and contributions that may be provided under a tax-qualified plan. In the case of a defined benefit plan, the limit on annual benefits payable under the plan is the lesser of: (1) a dollar amount which is adjusted for inflation ($175,000 for 2006); and (2) 100 percent of the participant's compensation for the highest three years. Special rules apply in some cases.

### *Explanation of Provision*

The provision provides that the 100 percent of compensation limit does not apply to a plan maintained by an organization described in section 3121(w)(3)(A) except with respect to "highly compensated benefits". The term "highly compensated benefits" means any benefits accrued for an employee in any year on or after the first year in which such employee is a highly compensated employee (as defined in sec. 414(q)) of the organization. For purposes of applying the 100 percent of compensation limit to highly compensated benefits, all the benefits of the employee which would otherwise be taken into account in applying the limit shall be taken into account, i.e., the limit does not apply only to those benefits accrued on or after the first year in which the employee is a highly compensated employee.

### *Effective Date*

The provision is effective for years beginning after December 31, 2006.

## 8. Gratuitous transfers for the benefit of employees (sec. 868 of the Act and sec. 664 of the Code)

### *Present Law*

Present law permits certain limited transfers of qualified employer securities by charitable remainder trusts to an employee stock ownership plan ("ESOP") without adversely affecting the status of the charitable remainder trusts under section 664. In addition, the ESOP does not fail to be a qualified plan because it complies with the requirements with respect to a qualified gratuitous transfer.

A number of requirements must be satisfied for a transfer of securities to be a qualified gratuitous transfer, including the following: (1) the securities transferred to the ESOP must previously have passed from the decedent to a charitable remainder trust; (2) at the time of the transfer to the ESOP, family members own no more than a certain percentage of the outstanding stock of the company; (3) immediately after the transfer the ESOP owns at least 60 percent of the value of the outstanding stock of company; and (4) the ESOP meets certain requirements.

Among other requirements applicable to the ESOP, securities transferred to the ESOP are required to be allocated each year up to the applicable limit (after first allocating all other annual additions for the limitation year). The applicable limit is the lesser of (1) $30,000 (as indexed) or (2) 25 percent of the participant's compensation.

### *Explanation of Provision*

The provision clarifies that, under section 664, the amount of transferred securities required to be allocated each year is determined on the basis of fair market value of the securities when allocated to participants.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## TITLE IX: INCREASE IN PENSION PLAN DIVERSIFICATION AND PARTICIPATION AND OTHER PENSION PROVISIONS

### A. Defined Contribution Plans Required to Provide Employees with Freedom to Invest Their Plan Assets (sec. 901 of the Act, new sec. 401(a)(35) of the Code, and new sec. 204(j) of ERISA)

#### *Present Law*

***In general***

Defined contribution plans may permit both employees and employers to make contributions to the plan. Under a qualified cash or deferred arrangement (commonly referred to as a "section 401(k) plan"), employees may elect to make pretax contributions to a plan, referred to as elective deferrals. Employees may also be permitted to make after-tax contributions to a plan. In addition, a plan may provide for employer nonelective contributions or matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes elective deferrals or after-tax contributions. Matching contributions are employer contributions that are made only if the employee makes elective deferrals or after-tax contributions.

Under the Code, elective deferrals, after-tax employee contributions, and employer matching contributions are subject to special nondiscrimination tests. Certain employer nonelective contributions may be used to satisfy these special nondiscrimination tests. In addition, plans may satisfy the special nondiscrimination tests by meeting certain safe harbor contribution requirements.

The Code requires employee stock ownership plans ("ESOPs") to offer certain plan participants the right to diversify investments in employer securities. The Employee Retirement Income Security Act of 1974 ("ERISA") limits the amount of employer securities and employer real property that can be acquired or held by certain employer-sponsored retirement plans. The extent to which the ERISA limits apply depends on the type of plan and the type of contribution involved.

***Diversification requirements applicable to ESOPs under the Code***

An ESOP is a defined contribution plan that is designated as an ESOP and is designed to invest primarily in qualifying employer securities and that meets certain other requirements under the Code. For purposes of ESOP investments, a "qualifying employer security" is defined as: (1) publicly traded common stock of the employer or a member of the same controlled group; (2) if there is no such publicly traded common stock, common stock of the employer

(or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or (3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP.

An ESOP can be an entire plan or it can be a component of a larger defined contribution plan. An ESOP may provide for different types of contributions. For example, an ESOP may include a qualified cash or deferred arrangement that permits employees to make elective deferrals.[661]

Under the Code, ESOPs are subject to a requirement that a participant who has attained age 55 and who has at least 10 years of participation in the plan must be permitted to diversify the investment of the participant's account in assets other than employer securities.[662] The diversification requirement applies to a participant for six years, starting with the year in which the individual first meets the eligibility requirements (i.e., age 55 and 10 years of participation). The participant must be allowed to elect to diversify up to 25 percent of the participant's account (50 percent in the sixth year), reduced by the portion of the account diversified in prior years.

The participant must be given 90 days after the end of each plan year in the election period to make the election to diversify. In the case of participants who elect to diversify, the plan satisfies the diversification requirement if: (1) the plan distributes the applicable amount to the participant within 90 days after the election period; (2) the plan offers at least three investment options (not inconsistent with Treasury regulations) and, within 90 days of the election period, invests the applicable amount in accordance with the participant's election; or (3) the applicable amount is transferred within 90 days of the election period to another qualified defined contribution plan of the employer providing investment options in accordance with (2).[663]

### *ERISA limits on investments in employer securities and real property*

ERISA imposes restrictions on the investment of retirement plan assets in employer securities or employer real property.[664] A retirement plan may hold only a "qualifying" employer security and only "qualifying" employer real property.

Under ERISA, any stock issued by the employer or an affiliate of the employer is a qualifying employer security.[665] Qualifying employer securities also include certain publicly traded partnership interests and certain marketable obligations (i.e., a bond, debenture, note, certificate or other evidence of indebtedness). Qualifying

[661] Such an ESOP design is sometimes referred to as a "KSOP."

[662] Sec. 401(a)(28). The present-law diversification requirements do not apply to employer securities held by an ESOP that were acquired before January 1, 1987.

[663] IRS Notice 88–56, 1988–1 C.B. 540, Q&A–16.

[664] ERISA sec. 407.

[665] Certain additional requirements apply to employer stock held by a defined benefit pension plan or a money purchase pension plan (other than certain plans in existence before the enactment of ERISA).

employer real property means parcels of employer real property: (1) if a substantial number of the parcels are dispersed geographically; (2) if each parcel of real property and the improvements thereon are suitable (or adaptable without excessive cost) for more than one use; (3) even if all of the real property is leased to one lessee (which may be an employer, or an affiliate of an employer); and (4) if the acquisition and retention of such property generally comply with the fiduciary rules of ERISA (with certain specified exceptions).

ERISA also prohibits defined benefit pension plans and money purchase pension plans (other than certain plans in existence before the enactment of ERISA) from acquiring employer securities or employer real property if, after the acquisition, more than 10-percent of the assets of the plan would be invested in employer securities and real property. Except as discussed below with respect to elective deferrals, this 10-percent limitation generally does not apply to defined contribution plans other than money purchase pension plans.[666] In addition, a fiduciary generally is deemed not to violate the requirement that plan assets be diversified with respect to the acquisition or holding of employer securities or employer real property in a defined contribution plan.[667]

The 10-percent limitation on the acquisition of employer securities and real property applies separately to the portion of a plan consisting of elective deferrals (and earnings thereon) if any portion of an individual's elective deferrals (or earnings thereon) are required to be invested in employer securities or real property pursuant to plan terms or the direction of a person other than the participant. This restriction does not apply if: (1) the amount of elective deferrals required to be invested in employer securities and real property does not exceed more than one percent of any employee's compensation; (2) the fair market value of all defined contribution plans maintained by the employer is no more than 10 percent of the fair market value of all retirement plans of the employer; or (3) the plan is an ESOP.

## *Explanation of Provision*

### *In general*

Under the provision, in order to satisfy the plan qualification requirements of the Code and the vesting requirements of ERISA, certain defined contribution plans are required to provide diversification rights with respect to amounts invested in employer securities. Such a plan is required to permit applicable individuals to direct that the portion of the individual's account held in employer securities be invested in alternative investments. An applicable individual includes: (1) any plan participant; and (2) any beneficiary who has an account under the plan with respect to which the beneficiary is entitled to exercise the rights of a participant. The time when the diversification requirements apply depends on the type of contributions invested in employer securities.

---

[666] The 10-percent limitation also applies to a defined contribution plan that is part of an arrangement under which benefits payable to a participant under a defined benefit pension plan are reduced by benefits under the defined contribution plan (i.e., a "floor-offset" arrangement).

[667] Under ERISA, a defined contribution plan is generally referred to as an individual account plan. Plans that are not subject to the 10-percent limitation on the acquisition of employer securities and employer real property are referred to as "eligible individual account plans."

***Plans subject to requirements***

The diversification requirements generally apply to an "applicable defined contribution plan,"[668] which means a defined contribution plan holding publicly-traded employer securities (i.e., securities issued by the employer or a member of the employer's controlled group of corporations[669] that are readily tradable on an established securities market).

For this purpose, a plan holding employer securities that are not publicly traded is generally treated as holding publicly-traded employer securities if the employer (or any member of the employer's controlled group of corporations) has issued a class of stock that is a publicly- traded employer security. This treatment does not apply if neither the employer nor any parent corporation[670] of the employer has issued any publicly-traded security or any special class of stock that grants particular rights to, or bears particular risks for, the holder or the issuer with respect to any member of the employer's controlled group that has issued any publicly-traded employer security. For example, a controlled group that generally consists of corporations that have not issued publicly-traded securities may include a member that has issued publicly-traded stock (the "publicly-traded member"). In the case of a plan maintained by an employer that is another member of the controlled group, the diversification requirements do not apply to the plan, provided that neither the employer nor a parent corporation of the employer has issued any publicly-traded security or any special class of stock that grants particular rights to, or bears particular risks for, the holder or issuer with respect to the member that has issued publicly-traded stock. The Secretary of the Treasury has the authority to provide other exceptions in regulations. For example, an exception may be appropriate if no stock of the employer maintaining the plan (including stock held in the plan) is publicly traded, but a member of the employer's controlled group has issued a small amount of publicly-traded stock.

The diversification requirements do not apply to an ESOP that: (1) does not hold contributions (or earnings thereon) that are subject to the special nondiscrimination tests that apply to elective deferrals, employee after-tax contributions, and matching contributions; and (2) is a separate plan from any other qualified retirement plan of the employer. Accordingly, an ESOP that holds elective deferrals, employee contributions, employer matching contributions, or nonelective employer contributions used to satisfy the special nondiscrimination tests (including the safe harbor methods of satisfying the tests) is subject to the diversification requirements under the provision. The diversification rights applicable under the provision are broader than those applicable under the Code's present-law ESOP diversification rules. Thus, an ESOP that is sub-

[668] Under ERISA, the diversification requirements apply to an "applicable individual account plan."

[669] For this purpose, "controlled group of corporations" has the same meaning as under section 1563(a), except that, in applying that section, 50 percent is substituted for 80 percent.

[670] For this purpose, "parent corporation" has the same meaning as under section 424(e), i.e., any corporation (other than the employer) in an unbroken chain of corporations ending with the employer if each corporation other than the employer owns stock possessing at least 50 percent of the total combined voting power of all classes of stock with voting rights or at least 50 percent of the total value of shares of all classes of stock in one of the other corporations in the chain.

ject to the new requirements is excepted from the present-law rules.[671]

The new diversification requirements also do not apply to a one-participant retirement plan. For purposes of the Code, a one-participant retirement plan is a plan that: (1) on the first day of the plan year, either covered only one individual (or the individual and his or her spouse) and the individual owned 100 percent of the plan sponsor (i.e., the employer maintaining the plan), whether or not incorporated, or covered only one or more partners (or partners and their spouses) in the plan sponsor; (2) meets the minimum coverage requirements without being combined with any other plan of the business that covers employees of the business; (3) does not provide benefits to anyone except the individuals and partners (and spouses) described in (1); (4) does not cover a business that is a member of an affiliated service group, a controlled group of corporations, or a group of corporations under common control; and (5) does not cover a business that uses the services of leased employees.[672] It is intended that, for this purpose, a "partner" includes an owner of a business that is treated as a partnership for tax purposes. In addition, it includes a two-percent shareholder of an S corporation.[673]

### *Elective deferrals and employee contributions*

In the case of amounts attributable to elective deferrals under a qualified cash or deferred arrangement and employee contributions that are invested in employer securities, any applicable individual must be permitted to direct that such amounts be invested in alternative investments.

### *Other contributions*

In the case of amounts attributable to contributions other than elective deferrals and employees contributions (i.e., nonelective employer contributions and employer matching contributions) that are invested in employer securities, an applicable individual who is a participant with three years of service,[674] a beneficiary of such a participant, or a beneficiary of a deceased participant must be permitted to direct that such amounts be invested in alternative investments.

A transition rule applies to amounts attributable to these other contributions that are invested in employer securities acquired before the first plan year for which the new diversification requirements apply. Under the transition rule, for the first three years for which the new diversification requirements apply to the plan, the applicable percentage of such amounts is subject to diversification as shown in Table 8, below. The applicable percentage applies separately to each class of employer security in an applicable individual's account. The transition rule does not apply to plan partici-

[671] An ESOP will not be treated as failing to be designed to invest primarily in qualifying employer securities merely because the plan provides diversification rights as required under the provision or greater diversification rights than required under the provision.

[672] For purposes of ERISA, a one-participant retirement plan is defined as under the provision of ERISA that requires advance notice of a blackout period to be provided to participants and beneficiaries affected by the blackout period, as discussed below.

[673] Under section 1372, a two-percent shareholder of an S corporation is treated as a partner for fringe benefit purposes.

[674] Years of service is defined as under the rules relating to vesting (sec. 411(a)).

pants who have three years of service and who have attained age 55 by the beginning of the first plan year beginning after December 31, 2005.

**Table 8.—Applicable Percentage for Employer Securities Held on Effective Date**

| Plan year for which diversification applies | Applicable percentage |
|---|---|
| First year | 33 |
| Second year | 66 |
| Third year | 100 |

The application of the transition rule is illustrated by the following example. Suppose that the account of a participant with at least three years of service held 120 shares of employer common stock contributed as matching contributions before the diversification requirements became effective. In the first year for which diversification applies, 33 percent (i.e., 40 shares) of that stock is subject to the diversification requirements. In the second year for which diversification applies, a total of 66 percent of 120 shares of stock (i.e., 79 shares, or an additional 39 shares) is subject to the diversification requirements. In the third year for which diversification applies, 100 percent of the stock, or all 120 shares, is subject to the diversification requirements. In addition, in each year, employer stock in the account attributable to elective deferrals and employee contributions is fully subject to the diversification requirements, as is any new stock contributed to the account.

***Rules relating to the election of investment alternatives***

A plan subject to the diversification requirements is required to give applicable individuals a choice of at least three investment options, other than employer securities, each of which is diversified and has materially different risk and return characteristics. It is intended that other investment options generally offered by the plan also must be available to applicable individuals.

A plan does not fail to meet the diversification requirements merely because the plan limits the times when divestment and reinvestment can be made to periodic, reasonable opportunities that occur at least quarterly. It is intended that applicable individuals generally be given the opportunity to make investment changes with respect to employer securities on the same basis as the opportunity to make other investment changes, except in unusual circumstances. Thus, in general, applicable individuals must be given the opportunity to request changes with respect to investments in employer securities with the same frequency as the opportunity to make other investment changes and such changes must be implemented in the same timeframe as other investment changes, unless circumstances require different treatment.

Except as provided in regulations, a plan may not impose restrictions or conditions with respect to the investment of employer securities that are not imposed on the investment of other plan assets (other than restrictions or conditions imposed by reason of the ap-

plication of securities laws). For example, such a restriction or condition includes a provision under which a participant who divests his or her account of employer securities receives less favorable treatment (such as a lower rate of employer contributions) than a participant whose account remains invested in employer securities. On the other hand, such a restriction does not include the imposition of fees with respect to other investment options under the plan, merely because fees are not imposed with respect to investments in employer securities.

### *Effective Date*

The provision is effective for plan years beginning after December 31, 2006.

In the case of a plan maintained pursuant to one or more collective bargaining agreements, the provision is effective for plan years beginning after the earlier of (1) the later of December 31, 2007, or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after the date of enactment (August 17, 2006)), or (2) December 31, 2008.

A special effective date applies with respect to employer matching and nonelective contributions (and earnings thereon) that are invested in employer securities that, as of September 17, 2003: (1) consist of preferred stock; and (2) are held within an ESOP, under the terms of which the value of the preferred stock is subject to a guaranteed minimum. Under the special rule, the diversification requirements apply to such preferred stock for plan years beginning after the earlier of (1) December 31, 2007; or (2) the first date as of which the actual value of the preferred stock equals or exceeds the guaranteed minimum. When the new diversification requirements become effective for the plan under the special rule, the applicable percentage of employer securities held on the effective date that is subject to diversification is determined without regard to the special rule.

## B. Increase Participation Through Automatic Enrollment Arrangements (sec. 902 of the Act, secs. 404(c) and 514 of ERISA, and secs. 401(k), 401(m), 414 and 4979 of the Code)

### *Present Law*

#### *Qualified cash or deferred arrangements—in general*

Under present law, most defined contribution plans may include a qualified cash or deferred arrangement (commonly referred to as a "section 401(k)" or "401(k)" plan),[675] under which employees may elect to receive cash or to have contributions made to the plan by the employer on behalf of the employee in lieu of receiving cash. Contributions made to the plan at the election of the employee are

[675] Legally, a section 401(k) plan is not a separate type of plan, but is a profit-sharing, stock bonus, or pre-ERISA money purchase plan that contains a qualified cash or deferred arrangement. The terms "section 401(k) plan" and "401(k) plan" are used here for convenience.

referred to as "elective deferrals" or "elective contributions".[676] A 401(k) plan may be designed so that the employee will receive cash unless an affirmative election to make contributions is made. Alternatively, a plan may provide that elective contributions are made at a specified rate unless the employee elects otherwise (i.e., elects not to make contributions or to make contributions at a different rate). Arrangements that operate in this manner are sometimes referred to as "automatic enrollment" or "negative election" plans. In either case, the employee must have an effective opportunity to elect to receive cash in lieu of contributions.[677]

***Nondiscrimination rules***

A special nondiscrimination test applies to elective deferrals under a section 401(k) plan, called the actual deferral percentage test or the "ADP" test. The ADP test compares the actual deferral percentages ("ADPs") of the highly compensated employee group and the nonhighly compensated employee group. The ADP for each group generally is the average of the deferral percentages separately calculated for the employees in the group who are eligible to make elective deferrals for all or a portion of the relevant plan year. Each eligible employee's deferral percentage generally is the employee's elective deferrals for the year divided by the employee's compensation for the year.

The plan generally satisfies the ADP test if the ADP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ADP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ADP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ADP of the nonhighly compensated employee group for the prior plan year.

Under a safe harbor, a section 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement (a "safe harbor section 401(k) plan"). A plan satisfies the contribution requirement under the safe harbor rule if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement. A plan generally satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee's elective deferrals up to three percent of compensation and (b) 50 percent of the employee's elective deferrals from three to five percent of compensa-

[676] The maximum annual amount of elective deferrals that can be made by an individual is subject to a limit ($15,000 for 2006). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a section 401(k) plan, subject to a limit ($5,000 for 2006).

[677] Treasury regulations provide that whether an employee has an effective opportunity to receive cash is based on all the relevant facts and circumstances, including the adequacy of notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections. Treas. Reg. sec. 1.401(k)–1(e)(2).

tion;[678] and (2) the rate of match with respect to any elective deferrals for highly compensated employees is not greater than the rate of match for nonhighly compensated employees.

Employer matching contributions are also subject to a special nondiscrimination test, the "ACP test," which compares the average actual contribution percentages ("ACPs") of matching contributions for the highly compensated employee group and the nonhighly compensated employee group. The plan generally satisfies the ACP test if the ACP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ACP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ACP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ACP of the nonhighly compensated employee group for the prior plan year.

A safe harbor section 401(k) plan that provides for matching contributions is deemed to satisfy the ACP test if, in addition to meeting the safe harbor contribution and notice requirements under section 401(k), (1) matching contributions are not provided with respect to elective deferrals in excess of six percent of compensation, (2) the rate of matching contribution does not increase as the rate of an employee's elective deferrals increases, and (3) the rate of matching contribution with respect to any rate of elective deferral of a highly compensated employee is no greater than the rate of matching contribution with respect to the same rate of deferral of a nonhighly compensated employee.

### *Top-heavy rules*

Special rules apply in the case of a top-heavy plan. In general, a defined contribution plan is a top-heavy plan if the accounts of key employees account for more than 60 percent of the aggregate value of accounts under the plan. If a plan is a top-heavy plan, then certain minimum vesting standards and minimum contribution requirements apply.

A plan that consists solely of contributions that satisfy the safe harbor plan rules for elective and matching contributions is not considered a top-heavy plan.

### *Tax-sheltered annuities*

Tax-sheltered annuities ("section 403(b) annuities") may provide for contributions on a salary reduction basis, similar to section 401(k) plans. Matching contributions under a section 403(b) annuity are subject to the same nondiscrimination rules under section 401(m) as matching contributions under a section 401(k) plan (sec. 403(b)(12)). Thus, for example, the safe harbor method of satisfying the section 401(m) rules for matching contributions under a 401(k) plan applies to section 403(b) annuities.

---

[678] In lieu of matching contributions at rates equal to the safe harbor rates, a plan may provide for an alternative match if (1) the rate of the matching contributions does not increase as an employee's rate of elective deferrals increases and (2) the amount of matching contributions at such rate of elective deferrals is at least equal to the aggregate amount of contributions which would be made if the rate of the matching contributions equaled the safe harbor rates.

***Excess elective contributions***

Present law provides special rules for distributions of elective contributions that exceed the amount permitted under the nondiscrimination rules or the dollar limit on such contributions.

***Fiduciary rules applicable to default investments of individual account plans***

ERISA imposes standards on the conduct of plan fiduciaries, including persons who make investment decisions with respect to plan assets. Fiduciaries are personally liable for any losses to the plan due to a violation of fiduciary standards.

An individual account plan may permit participants to make investment decisions with respect to their accounts. ERISA fiduciary liability does not apply to investment decisions made by plan participants if participants exercise control over the investment of their individual accounts, as determined under ERISA regulations. In that case, a plan fiduciary may be responsible for the investment alternatives made available, but not for the specific investment decisions made by participants.

***Preemption of State law***

ERISA generally preempts all State laws relating to employee benefit plans, other than generally applicable criminal laws and laws relating to insurance, banking, or securities.

***Excess contributions***

An excise tax is imposed on an employer making excess contributions or excess aggregate contributions to a qualified retirement plan. Excess contributions are elective contributions, including qualified nonelective contributions and qualified matching contributions that are treated as elective contributions, made to a plan on behalf of highly compensated employees to the extent that the contributions fail to satisfy the applicable nondiscrimination tests for such plan for the year. Excess aggregate contributions are the aggregate amount of employer matching contributions and employee after-tax contributions to a plan for highly compensated employees to the extent that the contributions fail to satisfy the applicable nondiscrimination tests for such plan for the year.

The excise tax is equal to 10 percent of the excess contributions or excess aggregate contributions under a plan for the plan year ending in the taxable year. The tax does not apply to any excess contributions or excess aggregate contributions that, together with income allocable to the contributions, are distributed or forfeited (if forfeitable) within 2½ months after the close of the plan year. Any excess contributions or excess aggregate contributions that are distributed within 2½ months after the close of the plan year are treated as received and earned by the recipient in the taxable year for which such contributions are made. If the total of such distributions to a recipient under a plan for any plan year is less than $100, such distributions (and any income allocable thereto) are treated as earned and received by the recipient in the taxable year in which the distributions are made.

Additionally, if certain requirements are met, excess contributions may be recharacterized as after-tax employee contributions,

no later than 2½ months after the close of the plan year to which the excess contributions relate.[679]

## *Explanation of Provision*

### *In general*

Under the provision, a 401(k) plan that contains an automatic enrollment feature that satisfies certain requirements (a "qualified automatic contribution arrangement") is treated as meeting the ADP test with respect to elective deferrals and the ACP test with respect to matching contributions. In addition, a plan consisting solely of contributions made pursuant to a qualified automatic contribution arrangement is not subject to the top-heavy rules.

A qualified automatic contribution arrangement must meet certain requirements with respect to: (1) automatic deferral; (2) matching or nonelective contributions; and (3) notice to employees.

### *Automatic deferral/amount of elective contributions*

A qualified automatic contribution arrangement must provide that, unless an employee elects otherwise, the employee is treated as making an election to make elective deferrals equal to a stated percentage of compensation not in excess of 10 percent and at least equal to: three percent of compensation for the first year the deemed election applies to the participant; four percent during the second year; five percent during the third year; and six percent during the fourth year and thereafter. The stated percentage must be applied uniformly to all eligible employees.

Eligible employees mean all employees eligible to participate in the arrangement, other than employees eligible to participate in the arrangement immediately before the date on which the arrangement became a qualified automatic contribution arrangement with an election in effect (either to participate at a certain percentage or not to participate).

### *Matching or nonelective contribution requirement*

#### *Contributions*

An automatic enrollment feature satisfies the contribution requirement if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the automatic enrollment feature. A plan generally satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to 100 percent of the employee's elective deferrals as do not exceed one percent of compensation and 50 percent of the employee's elective deferrals as exceeds one percent but does not exceed six percent of compensation and (2) the rate of match with respect to any elective deferrals for highly compensated employees is not greater than the rate of match for nonhighly compensated employees.

[679] Treas. Reg. sec. 1.401(k)–2(b)(3).

A plan including an automatic enrollment feature that provides for matching contributions is deemed to satisfy the ACP test if, in addition to meeting the safe harbor contribution requirements applicable to the qualified automatic enrollment feature: (1) matching contributions are not provided with respect to elective deferrals in excess of six percent of compensation, (2) the rate of matching contribution does not increase as the rate of an employee's elective deferrals increases, and (3) the rate of matching contribution with respect to any rate of elective deferral of a highly compensated employee is no greater than the rate of matching contribution with respect to the same rate of deferral of a nonhighly compensated employee.

*Vesting*

Any matching or other employer contributions taken into account in determining whether the requirements for a qualified automatic contribution arrangement are satisfied must vest at least as rapidly as under two-year cliff vesting. That is, employees with at least two years of service must be 100 percent vested with respect to such contributions.

*Withdrawal restrictions*

Under the provision, any matching or other employer contributions taken into account in determining whether the requirements for a qualified automatic enrollment feature are satisfied are subject to the withdrawal rules applicable to elective contributions.

***Notice requirement***

Under a notice requirement, each employee eligible to participate in the arrangement must receive notice of the arrangement which is sufficiently accurate and comprehensive to apprise the employee of such rights and obligations and is written in a manner calculated to be understood by the average employee to whom the arrangement applies. The notice must explain: (1) the employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf or to elect to have contributions made in a different amount; and (2) how contributions made under the automatic enrollment arrangement will be invested in the absence of any investment election by the employee. The employee must be given a reasonable period of time after receipt of the notice and before the first election contribution is to be made to make an election with respect to contributions and investments.

***Application to tax-sheltered annuities***

The new safe harbor rules for automatic contribution plans apply with respect to matching contributions under a section 403(b) annuity through the operation of section 403(b)(12).

***Corrective distributions***

The provision includes rules under which erroneous automatic contributions ("permissible withdrawals") may be distributed from the plan. Permissible withdrawals must be made pursuant to an election by the employee no later than 90 days after the date of the first elective contribution with respect to the employee under the

arrangement. The amount that is treated as a permissible withdrawal is limited to the amount of automatic contributions made during the 90-day period that the employee elects to treat as an erroneous contribution. It is intended that distributions of such amounts are generally treated as a payment of compensation, rather than as a contribution to and then a distribution from the plan. The 10-percent early withdrawal tax does not apply to distributions of erroneous automatic contributions. In addition, it is intended that such contributions are not taken into account for purposes of applying the nondiscrimination rules or the limit on elective deferrals. Distributions of such contributions are not subject to the otherwise applicable withdrawal restrictions. The rules for corrective distributions apply to distributions from (1) qualified pension plans under Code section 401(a), (2) plans under which amounts are contributed by an individual's employer for Code section 403(b) annuity contract and (3) governmental eligible deferred compensation plans under Code section 457(b).

The corrective distribution rules are not limited to arrangements meeting the requirements of a qualified automatic contribution arrangement.

***Excess contributions***

In the case of an eligible automatic contribution arrangement, the excise tax on excess contributions does not apply to any excess contributions or excess aggregate contributions which, together with income allocable to the contributions, are distributed or forfeited (if forfeitable) within six months after the close of the plan year. Additionally, any excess contributions or excess aggregate contributions (and any income allocable thereto) that are distributed within the period required to avoid application of the excise tax are treated as earned and received by the recipient in the taxable year in which the distribution is made (regardless of the amount distributed), and the income allocable to excess contributions or excess aggregate contributions that must be distributed is determined through the end of the year for which the contributions were made.

***Preemption of State law***

The provision preempts any State law that would directly or indirectly prohibit or restrict the inclusion in a plan of an automatic contribution arrangement. The Secretary of Labor may establish minimum standards for such arrangements in order for preemption to apply. An automatic contribution arrangement is an arrangement: (1) under which a participant may elect to have the plan sponsor make payments as contributions under the plan on behalf of the participant, or to the participant directly in cash, (2) under which a participant is treated as having elected to have the plan sponsor make such contributions in an amount equal to a uniform percentage of compensation provided under the plan until the participant specifically elects not to have such contributions made (or elects to have contributions made at a different percentage), and (3) under which contributions are invested in accordance with regulations issued by the Secretary of Labor relating to default investments as provided under the Act. The State law preemption rules

under the Act are not limited to arrangements that meet the requirements of a qualified automatic contribution arrangement.

A plan administrator must provide notice to each participant to whom the automatic contribution arrangement applies. If the notice requirement is not satisfied, an ERISA penalty of $1,100 per day applies.

### *Effective Date*

The provision is effective for years beginning after December 31, 2007. The preemption of conflicting State regulations is effective on the date of enactment (August 17, 2006). No inference is intended as to the effect of conflicting State regulations prior to date of enactment.

## C. Treatment of Eligible Combined Defined Benefit Plans and Qualified Cash or Deferred Arrangements (sec. 903 of the Act, new sec. 414(x) of the Code, and new sec. 210(e) of ERISA)

### *Present Law*

#### *In general*

Under present law, most defined contribution plans may include a qualified cash or deferred arrangement (commonly referred to as a "section 401(k)" or "401(k)" plan),[680] under which employees may elect to receive cash or to have contributions made to the plan by the employer on behalf of the employee in lieu of receiving cash (referred to as "elective deferrals" or "elective contributions").[681] A section 401(k) plan may provide that elective deferrals are made for an employee at a specified rate unless the employee elects otherwise (i.e., elects not to make contributions or to make contributions at a different rate), provided that the employee has an effective opportunity to elect to receive cash in lieu of the default contributions. Such a design is sometimes referred to as "automatic enrollment."

Besides elective deferrals, a section 401(k) plan may provide for: (1) matching contributions, which are employer contributions that are made only if an employee makes elective deferrals; and (2) nonelective contributions, which are employer contributions that are made without regard to whether an employee makes elective deferrals. Under a section 401(k) plan, no benefit other than matching contributions can be contingent on whether an employee makes elective deferrals. Thus, for example, an employee's eligibility for benefits under a defined benefit pension plan cannot be contingent on whether the employee makes elective deferrals.

A cash balance plan is a defined benefit pension plan with benefits resembling the benefits associated with defined contribution plans. Cash balance plans are sometimes referred to as "hybrid"

[680] Legally, a section 401(k) plan is not a separate type of plan, but is a profit-sharing, stock bonus, or pre-ERISA money purchase plan that contains a qualified cash or deferred arrangement. The terms "section 401(k) plan" and "401(k) plan" are used here for convenience.

[681] The maximum annual amount of elective deferrals that can be made by an individual is subject to a dollar limit ($15,000 for 2006). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a section 401(k) plan, subject to a limit ($5,000 for 2006).

plans because they combine features of a defined benefit pension plan and a defined contribution plan. Under a cash balance plan, benefits are determined by reference to a hypothetical account balance. An employee's hypothetical account balance is determined by reference to hypothetical annual allocations to the account ("pay credits") (e.g., a certain percentage of the employee's compensation for the year) and hypothetical earnings on the account ("interest credits"). Other types of hybrid plans exist as well, such as so-called "pension equity" plans.

The assets of a qualified retirement plan (either a defined contribution plan or a defined benefit pension plan) must be held in trust for the exclusive benefit of participants and beneficiaries. Defined benefit pension plans are subject to funding rules, which require employers to make contributions at specified minimum levels.[682] In addition, limits apply on the extent to which defined benefit pension plan assets may be invested in employer securities or real property. The minimum funding rules and limits on investments in employer securities or real property generally do not apply to defined contribution plans.

### *Nondiscrimination requirements*

Under a general nondiscrimination requirement, the contributions or benefits provided under a qualified retirement plan must not discriminate in favor of highly compensated employees.[683] Treasury regulations provide detailed and exclusive rules for determining whether a plan satisfies the general nondiscrimination rules. Under the regulations, the amount of contributions or benefits provided under the plan and the benefits, rights and features offered under the plan must be tested.

A special nondiscrimination test applies to elective deferrals under a section 401(k) plan, called the actual deferral percentage test or the "ADP" test. The ADP test compares the actual deferral percentages ("ADPs") of the highly compensated employee group and the nonhighly compensated employee group. The ADP for each group generally is the average of the deferral percentages separately calculated for the employees in the group who are eligible to make elective deferrals for all or a portion of the relevant plan year. Each eligible employee's deferral percentage generally is the employee's elective deferrals for the year divided by the employee's compensation for the year.

The plan generally satisfies the ADP test if the ADP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ADP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ADP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ADP of the nonhighly compensated employee group for the prior plan year.

---

[682] The Pension Benefit Guaranty Corporation generally guarantees a minimum level of benefits under a defined benefit plan.

[683] Under special rules, referred to as the permitted disparity rules, higher contributions or benefits can be provided to higher-paid employees in certain circumstances without violating the general nondiscrimination rules.

Under a safe harbor, a section 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement (a "safe harbor section 401(k) plan"). A plan satisfies the contribution requirement under the safe harbor rule if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement. A plan generally satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee's elective deferrals up to three percent of compensation and (b) 50 percent of the employee's elective deferrals from three to five percent of compensation; and (2) the rate of matching contribution with respect to any rate of elective deferrals of a highly compensated employee is not greater than the rate of matching contribution with respect to the same rate of elective deferral of a nonhighly compensated employee.[684]

Employer matching contributions are also subject to a special nondiscrimination test, the "ACP test," which compares the average actual contribution percentages ("ACPs") of matching contributions for the highly compensated employee group and the nonhighly compensated employee group. The plan generally satisfies the ACP test if the ACP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ACP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ACP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ACP of the nonhighly compensated employee group for the prior plan year.

A safe harbor section 401(k) plan that provides for matching contributions must satisfy the ACP test. Alternatively, it is deemed to satisfy the ACP test if it satisfies a matching contribution safe harbor, under which (1) matching contributions are not provided with respect to elective deferrals in excess of six percent of compensation, (2) the rate of matching contribution does not increase as the rate of an employee's elective deferrals increases, and (3) the rate of matching contribution with respect to any rate of elective deferral of a highly compensated employee is no greater than the rate of matching contribution with respect to the same rate of deferral of a nonhighly compensated employee.

### *Vesting rules*

A qualified retirement plan generally must satisfy one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the completion of five years of service. A plan satis-

[684] Alternatively, matching contributions may be provided at a different rate, provided that: (1) the rate of matching contribution doesn't increase as the rate of elective deferral increases; and (2) the aggregate amount of matching contributions with respect to each rate of elective deferral is not less than the amount that would be provided under the general rule.

fies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after three years of service, 40 percent after four years of service, 60 percent after five years of service, 80 percent after six years of service, and 100 percent after seven years of service.

Special vesting rules apply to elective deferrals and matching contributions. Elective deferrals must be immediately vested. Matching contributions generally must vest at least as rapidly as under one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of matching contributions upon the completion of three years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to 20 percent of matching contributions for each year of service beginning with the participant's second year of service and ending with 100 percent after six years of service. However, matching contributions under a safe harbor section 401(k) plan must be immediately vested.

***Top-heavy rules***

Under present law, a top-heavy plan is a qualified retirement plan under which cumulative benefits are provided primarily to key employees. An employee is considered a key employee if, during the prior year, the employee was (1) an officer with compensation in excess of a certain amount ($140,000 for 2006), (2) a five-percent owner, or (3) a one-percent owner with compensation in excess of $150,000. A plan that is top-heavy must provide (1) minimum employer contributions or benefits to participants who are not key employees and (2) more rapid vesting for participants who are not key employees (as discussed below).

In the case of a defined contribution plan, the minimum contribution is the lesser of (1) three percent of compensation, or (2) the highest percentage of compensation at which contributions were made for any key employee. In the case of a defined benefit pension, the minimum benefit is the lesser of (1) two percent of average compensation multiplied by the participant's years of service, or (2) 20 percent of average compensation. For this purpose, a participant's average compensation is generally average compensation for the consecutive-year period (not exceeding five years) during which the participant's aggregate compensation is the greatest.

Top-heavy plans must satisfy one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of contributions or benefits upon the completion of three years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to 20 percent of contributions or benefits for each year of service beginning with the participant's second year of service and ending with 100 percent after six years of service.[685]

A safe harbor section 401(k) plan is not subject to the top-heavy rules, provided that, if the plan provides for matching contributions, it must also satisfy the matching contribution safe harbor.

[685] The top-heavy vesting schedules are the same as the vesting schedules that apply to matching contributions.

***Other qualified retirement plan requirements***

Qualified retirement plans are subject to various other requirements, some of which depend on whether the plan is a defined contribution plan or a defined benefit pension. Such requirements include limits on contributions and benefits and spousal protections.

In the case of a defined contribution plan, annual additions with respect to each plan participant cannot exceed the lesser of: (1) 100 percent of the participant's compensation; or (2) a dollar amount, indexed for inflation ($44,000 for 2006). Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. In the case of a defined benefit pension, annual benefits payable under the plan generally may not exceed the lesser of: (1) 100 percent of average compensation; or (2) a dollar amount, indexed for inflation ($175,000 for 2006).

Defined benefit pension plans are required to provide benefits in the form of annuity unless the participant (and his or her spouse, in the case of a married participant) consents to another form of benefit. In addition, in the case of a married participant, benefits generally must be paid in the form of a qualified joint and survivor annuity ("QJSA") unless the participant and his or her spouse consent to a distribution in another form. A QJSA is an annuity for the life of the participant, with a survivor annuity for the life of the spouse which is not less than 50 percent (and not more than 100 percent) of the amount of the annuity payable during the joint lives of the participant and his or her spouse. These spousal protection requirements generally do not apply to a defined contribution plan that does not offer annuity distributions.

***Annual reporting by qualified retirement plans***

The plan administrator of a qualified retirement plan generally must file an annual return with the Secretary of the Treasury and an annual report with the Secretary of Labor. In addition, in the case of a defined benefit pension, certain information is generally required to be filed with the Pension Benefit Guaranty Corporation ("PBGC"). Form 5500, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 with the Department of Labor.

The Form 5500 is due by the last day of the seventh month following the close of the plan year. The due date may be extended up to two and one-half months. Copies of filed Form 5500s are available for public examination at the U.S. Department of Labor.

A plan administrator must automatically provide participants with a summary of the annual report within two months after the due date of the annual report (i.e., by the end of the ninth month after the end of the plan year unless an extension applies). In addition, a copy of the full annual report must be provided to participants on written request.

## *Explanation of Provision*

### *In general*

The provision provides rules for an "eligible combined plan." An eligible combined plan is a plan: (1) that is maintained by an employer that is a small employer at the time the plan is established; (2) that consists of a defined benefit plan and an "applicable" defined contribution plan; (3) the assets of which are held in a single trust forming part of the plan and are clearly identified and allocated to the defined benefit plan and the applicable defined contribution plan to the extent necessary for the separate application of the Code and ERISA; and (4) that meets certain benefit, contribution, vesting and nondiscrimination requirements as discussed below. For this purpose, an applicable defined contribution plan is a defined contribution plan that includes a qualified cash or deferred arrangement (i.e., a section 401(k) plan). A small employer is an employer that employed an average of at least two, but not more than 500, employees on business days during the preceding calendar year and at least two employees on the first day of the plan year.

Except as specified in the provision, the provisions of the Code and ERISA are applied to any defined benefit plan and any applicable defined contribution plan that are part of an eligible combined plan in the same manner as if each were not part of the eligible combined plan. Thus, for example, the present-law limits on contributions and benefits apply separately to contributions under an applicable defined contribution plan that is part of an eligible combined plan and to benefits under the defined benefit plan that is part of the eligible combined plan. In addition, the spousal protection rules apply to the defined benefit plan, but not to the applicable defined contribution plan except to the extent provided under present law. Moreover, although the assets of an eligible combined plan are held in a single trust, the funding rules apply to a defined benefit plan that is part of an eligible combined plan on the basis of the assets identified and allocated to the defined benefit, and the limits on investing defined benefit plan assets in employer securities or real property apply to such assets. Similarly, separate participant accounts are required to be maintained under the applicable defined contribution plan that is part of the eligible combined plan, and earnings (or losses) on participants' account are based on the earnings (or losses) with respect to the assets of the applicable defined contribution plan.

### *Requirements with respect to defined benefit plan*

A defined benefit plan that is part of an eligible combined plan is required to provide each participant with a benefit of not less than the applicable percentage of the participant's final average pay. The applicable percentage is the lesser of: (1) one percent multiplied by the participant's years of service; or (2) 20 percent. For this purpose, final average pay is determined using the consecutive-year period (not exceeding five years) during which the participant has the greatest aggregate compensation.

If the defined benefit plan is an applicable defined benefit plan,[686] the plan is treated as meeting this benefit requirement if each participant receives a pay credit for each plan year of not less than the percentage of compensation determined in accordance with the following table:

**Table 9.—Percentage of Compensation**

| Participant's age as of the beginning of the plan year | Percentage |
|---|---|
| 30 or less | 2 |
| Over 30 but less than 40 | 4 |
| Over 40 but less than 50 | 6 |
| 50 or over | 8 |

A defined benefit that is part of an eligible combined plan must provide the required benefit to each participant, regardless of whether the participant makes elective deferrals to the applicable defined contribution plan that is part of the eligible combined plan.

Any benefits provided under the defined benefit plan (including any benefits provided in addition to required benefits) must be fully vested after three years of service.

***Requirements with respect to applicable defined contribution plan***

Certain automatic enrollment and matching contribution requirements must be met with respect to an applicable defined contribution plan that is part of an eligible combined plan. First, the qualified cash or deferred arrangement under the plan must constitute an automatic contribution arrangement, under which each employee eligible to participate is treated as having elected to make deferrals of four percent of compensation unless the employee elects otherwise (i.e., elects not to make deferrals or to make deferrals at a different rate). Participants must be given notice of their right to elect otherwise and must be given a reasonable period of time after receiving notice in which to make an election. In addition, participants must be given notice of their rights and obligations within a reasonable period before each year.

Under the applicable defined contribution plan, the employer must be required to make matching contributions on behalf of each employee eligible to participate in the arrangement in an amount equal to 50 percent of the employee's elective deferrals up to four percent of compensation, and the rate of matching contribution with respect to any elective deferrals for highly compensated employees must not be not greater than the rate of match for non-highly compensated employees.[687] Matching contributions in addition to the required matching contributions may also be made. The employer may also make nonelective contributions under the applicable defined contribution plan, but any nonelective contributions

[686] Applicable defined benefit plan is defined as under the Title VII of the Act.

[687] As under present law, matching contributions may be provided at a different rate, provided that: (1) the rate of matching contribution doesn't increase as the rate of elective deferral increases; and (2) the aggregate amount of matching contributions with respect to each rate of elective deferral is not less than the amount that would be provided under the general rule.

are not taken into account in determining whether the matching contribution requirement is met.

Any matching contributions under the applicable defined contribution plan (including any in excess of required matching contributions) must be fully vested when made. Any nonelective contributions made under the applicable defined contribution plan must be fully vested after three years of service.

### *Nondiscrimination and other rules*

An applicable defined contribution plan satisfies the ADP test on a safe-harbor basis. Matching contributions under an applicable defined contribution plan must satisfy the ACP test or may satisfy the matching contribution safe harbor under present law, as modified to reflect the matching contribution requirements applicable under the provision.

Nonelective contributions under an applicable defined contribution plan and benefits under a defined benefit plan that are part of an eligible combined plan are generally subject to the nondiscrimination rules as under present law. However, neither a defined benefit plan nor an applicable defined contribution plan that is part of an eligible combined plan may be combined with another plan in determining whether the nondiscrimination requirements are met.[688]

An applicable defined contribution plan and a defined benefit plan that are part of an eligible combined plan are treated as meeting the top-heavy requirements.

All contributions, benefits, and other rights and features that are provided under a defined benefit plan or an applicable defined contribution plan that is part of an eligible combined plan must be provided uniformly to all participants. This requirement applies regardless of whether nonuniform contributions, benefits, or other rights or features could be provided without violating the nondiscrimination rules. However, it is intended that a plan will not violate the uniformity requirement merely because benefits accrued for periods before a defined benefit or defined contribution plan became part of an eligible combined plan are protected (as required under the anticutback rules).

### *Annual reporting*

An eligible combined plan is treated as a single plan for purposes of annual reporting. Thus, only a single Form 5500 is required. All of the information required under present law with respect to a defined benefit plan or a defined contribution plan must be provided in the Form 5500 for the eligible combined plan. In addition, only a single summary annual report must be provided to participants.

### *Other rules*

The provision of the Act relating to default investment options and the preemption of State laws with respect to automatic enrollment arrangements are applicable to eligible combined plans. It is

[688] The permitted disparity rules do not apply in determining whether an applicable defined contribution plan or a defined benefit plan that is part of an eligible combined plan satisfies (1) the contribution or benefit requirements under the provision or (2) the nondiscrimination requirements.

intended that in the case that an eligible combined plan terminates, the PBGC guarantee applies only to benefits under the defined benefit portion of the plan.

### *Effective Date*

The provision is effective for plan years beginning after December 31, 2009.

## D. Faster Vesting of Employer Nonelective Contributions (sec. 904 of the Act, sec. 203 of ERISA, and sec. 411 of the Code)

### *Present Law*

Under present law, in general, a plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the completion of five years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after three years of service, 40 percent after four years of service, 60 percent after five years of service, 80 percent after six years of service, and 100 percent after seven years of service.[689]

Faster vesting schedules apply to employer matching contributions. Employer matching contributions are required to vest at least as rapidly as under one of the following two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of employer matching contributions upon the completion of three years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to 20 percent of employer matching contributions for each year of service beginning with the participant's second year of service and ending with 100 percent after six years of service.

### *Explanation of Provision*

The provision applies the present-law vesting schedule for matching contributions to all employer contributions to defined contribution plans.

The provision does not apply to any employee until the employee has an hour of service after the effective date. In applying the new vesting schedule, service before the effective date is taken into account.

### *Effective Date*

The provision is generally effective for contributions for plan years beginning after December 31, 2006.

---

[689] The minimum vesting requirements are also contained in Title I of the Employee Retirement Income Security Act of 1974 ("ERISA").

In the case of a plan maintained pursuant to one or more collective bargaining agreements, the provision is not effective for contributions (including allocations of forfeitures) for plan years beginning before the earlier of (1) the later of the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof on or after the date of enactment (August 17, 2006)) or January 1, 2007, or (2) January 1, 2009.

In the case of an employee stock ownership plan ("ESOP") which on September 26, 2005, had outstanding a loan incurred for the purpose of acquiring qualifying employer securities, the provision does not apply to any plan year beginning before the earlier of (1) the date on which the loan is fully repaid, or (2) the date on which the loan was, as of September 26, 2005, scheduled to be fully repaid.

## E. Distributions During Working Retirement (sec. 905 of the Act, sec. 3(2) of ERISA, and new sec. 401(a)(35) of the Code)

### *Present Law*

Under ERISA, a pension plan is a plan, fund, or program established or maintained by an employer or an employee organization, or by both, to the extent that, by its express terms or surrounding circumstances, the plan, fund, or program: (1) provides retirement income to employees, or (2) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, regardless of the method of calculating contributions made to or benefits under the plan or the method of distributing benefits from the plan.

For purposes of the qualification requirements applicable to pension plans, stock bonus plans, and profit-sharing plans under the Code, a pension plan is a plan established and maintained primarily to provide systematically for the payment of definitely determinable benefits to employees over a period of years, usually life, after retirement.[690] A pension plan (i.e., a defined benefit plan or money purchase pension plan) may not provide for distributions before the attainment of normal retirement age (commonly age 65) to participants who have not separated from employment.[691]

Under proposed regulations, in the case of a phased retirement program, a pension plan is permitted to pay a portion of a participant's benefits before attainment of normal retirement age.[692] A phased retirement program is a program under which employees who are at least age 59½ and are eligible for retirement may reduce (by at least 20 percent) the number of hours they customarily work and receive a pro rata portion of their retirement benefits, based on the reduction in their work schedule.

### *Explanation of Provision*

Under the provision, for purposes of the definition of pension plan under ERISA, a distribution from a plan, fund, or program is

[690] Treas. Reg. sec. 1.401–1(b)(1)(i).
[691] See, e.g., Rev. Rul. 74–254.
[692] Prop. Treas. Reg. secs. 1.401(a)–1(b)(1)(iv) and 1.401(a)–3.

not treated as made in a form other than retirement income or as a distribution prior to termination of covered employment solely because the distribution is made to an employee who has attained age 62 and who is not separated from employment at the time of such distribution.

In addition, under the Code, a pension plan does not fail to be a qualified retirement plan solely because the plan provides that a distribution may be made to an employee who has attained age 62 and who is not separated from employment at the time of the distribution.

### *Effective Date*

The provision is effective for distributions in plan years beginning after December 31, 2006.

## F. Treatment of Plans Maintained by Indian Tribes (sec. 906 of the Act, sec. 414(d) of the Code, and sec. 3(32) of ERISA)

### *Present Law*

Governmental plans are exempt from ERISA and from Code requirements that correspond to ERISA requirements, such as the vesting rules and the funding rules. A governmental plan is generally a plan established and maintained for its employees by (1) the Federal Government, (2) the government of a State or political subdivision of a State, or (3) any agency or instrumentality of any of the foregoing.

Benefits under a defined benefit pension plan generally cannot exceed the lesser of (1) 100 percent of average compensation, or (2) a dollar amount ($175,000 for 2006), subject to certain special rules for defined benefit plans maintained by State and local government employers and other special rules for employees of a police or fire department. Employee contributions to a defined benefit pension plan are generally subject to tax; however, employee contributions may be made to a State or local government defined benefit pension plan on a pretax basis (referred to as "pickup" contributions).

Governmental defined benefit pension plans are not covered by the PBGC insurance program.

### *Explanation of Provision*

Under the provision, the term "governmental plan" for purposes of section 414 of the Code, section 3(32) of ERISA, and the PBGC termination insurance program includes a plan: (1) which is established and maintained by an Indian tribal government (as defined in Code sec. 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with Code sec. 7871(d)), or an agency or instrumentality of either; and (2) all of the participants of which are qualified employees of such entity. A qualified employee is an employee of an entity described in (1), substantially all of whose services for such entity are in the performance of essential governmental services and not in the performance of commercial activities (whether or not such activities are an essential governmental function). Thus, for example, a governmental plan would include a plan of a tribal government all of the participants of which

are teachers in tribal schools. On the other hand, a governmental plan would not include a plan covering tribal employees who are employed by a hotel, casino, service station, convenience store, or marina operated by a tribal government.

Under the provision, the special benefit limitations applicable to employees of police and fire departments of a State or political subdivision (Code sec. 415(b)(2)(H)) apply to such employees of an Indian tribe or any political subdivision thereof. In addition, the rules relating to pickup contributions under governmental plans (Code sec. 414(h)) and special benefit limitations for governmental plans (sec. 415(b)(10)) apply to tribal plans treated as governmental plans under the provision.

### *Effective Date*

The provision is effective for years beginning on or after the date of enactment (August 17, 2006).

## TITLE X—SPOUSAL PENSION PROTECTION

### A. Regulations on Time and Order of Issuance of Domestic Relations Orders (sec. 1001 of the Act)

#### *Present Law*

Benefits provided under a qualified retirement plan for a participant may not be assigned or alienated to creditors of the participant, except in very limited circumstances.[693] One exception to the prohibition on assignment or alienation is a qualified domestic relations order ("QDRO").[694] A QDRO is a domestic relations order that creates or recognizes a right of an alternate payee, including a former spouse, to any plan benefit payable with respect to a participant and that meets certain procedural requirements. In addition, a QDRO generally may not require the plan to provide any type or form of benefit, or any option, not otherwise provided under the plan, or to provide increased benefits.

Present law also provides that a QDRO may not require the payment of benefits to an alternate payee that are required to be paid to another alternate payee under a domestic relations order previously determined to be a QDRO. This rule implicitly recognizes that a domestic relations order issued after a QDRO may also qualify as a QDRO. However, present law does not otherwise provide specific rules for the treatment of a domestic relations order as a QDRO if the order is issued after another domestic relations order or a QDRO (including an order issued after a divorce decree) or revises another domestic relations order or a QDRO.

Present law provides specific rules that apply during any period in which the status of a domestic relations order as a QDRO is being determined (by the plan administrator, by a court, or otherwise). During such a period, the plan administrator is required to account separately for the amounts that would have been payable to the alternate payee during the period if the order had been determined to be a QDRO (referred to as "segregated amounts"). If, within the 18-month period beginning with the date on which the first payment would be required to be made under the order, the order (or modification thereof) is determined to be a QDRO, the plan administrator is required to pay the segregated amounts (including any interest thereon) to the person or persons entitled thereto. If, within the 18-month period, the order is determined not to be a QDRO, or its status as a QDRO is not resolved, the plan administrator is required to pay the segregated amounts (including any interest) to the person or persons who would be entitled to such amounts if there were no order. In such a case, any subse-

[693] Code sec. 401(a)(13); ERISA sec. 206(d).
[694] Code secs. 401(a)(13)(B) and 414(p); ERISA sec. 206(d)(3).

quent determination that the order is a QDRO is applied prospectively only.

### *Explanation of Provision*

The Secretary of Labor is directed to issue, not later than one year after the date of enactment of the provision, regulations to clarify the status of certain domestic relations orders. In particular, the regulations are to clarify that a domestic relations order otherwise meeting the QDRO requirements will not fail to be treated as a QDRO solely because of the time it is issued or because it is issued after or revises another domestic relations order or QDRO. The regulations are also to clarify that such a domestic relations order is in all respects subject to the same requirements and protections that apply to QDROs. For example, as under present law, such a domestic relations order may not require the payment of benefits to an alternate payee that are required to be paid to another alternate payee under an earlier QDRO. In addition, the present-law rules regarding segregated amounts that apply while the status of a domestic relations order as a QDRO is being determined continue to apply.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## B. Benefits Under the Railroad Retirement System for Former Spouses (secs. 1002 and 1003 of the Act, and secs. 2 and 5 of the Railroad Retirement Act of 1974)

### *Present Law*

#### *In general*

The Railroad Retirement System has two main components. Tier I of the system is financed by taxes on employers and employees equal to the Social Security payroll tax and provides qualified railroad retirees (and their qualified spouses, dependents, widows, or widowers) with benefits that are roughly equal to Social Security. Covered railroad workers and their employers pay the Tier I tax instead of the Social Security payroll tax, and most railroad retirees collect Tier I benefits instead of Social Security. Tier II of the system replicates a private pension plan, with employers and employees contributing a certain percentage of pay toward the system to finance defined benefits to eligible railroad retirees (and qualified spouses, dependents, widows, or widowers) upon retirement; however, the Federal Government collects the Tier II payroll contribution and pays out the benefits.

#### *Former spouses of living railroad employees*

Generally, a former spouse of a railroad employee who is otherwise eligible for any Tier I or Tier II benefit cannot receive either benefit until the railroad employee actually retires and begins receiving his or her retirement benefits. This is the case regardless of whether a State divorce court has awarded such railroad retirement benefits to the former spouse.

***Former spouses of deceased railroad employees***

The former spouse of a railroad employee may be eligible for survivors' benefits under Tier I of the Railroad Retirement System. However, a former spouse loses eligibility for any otherwise allowable Tier II benefits upon the death of the railroad employee.

### *Explanation of Provision*

***Former spouses of living railroad employees***

The provision eliminates the requirement that a railroad employee actually receive railroad retirement benefits for the former spouse to be entitled to any Tier I benefit or Tier II benefit awarded under a State divorce court decision.

***Former spouses of deceased railroad employees***

The provision provides that a former spouse of a railroad employee does not lose eligibility for otherwise allowable Tier II benefits upon the death of the railroad employee.

### *Effective Date*

The provision is effective one year after the date of enactment (August 17, 2006).

## C. Requirement for Additional Survivor Annuity Option (sec. 1004 of the Act, sec. 417 of the Code, and sec. 205 of ERISA)

### *Present Law*

Defined benefit pension plans and money purchase pension plans are required to provide benefits in the form of a qualified joint and survivor annuity ("QJSA") unless the participant and his or her spouse consent to another form of benefit. A QJSA is an annuity for the life of the participant, with a survivor annuity for the life of the spouse which is not less than 50 percent (and not more than 100 percent) of the amount of the annuity payable during the joint lives of the participant and his or her spouse.[695] In the case of a married participant who dies before the commencement of retirement benefits, the surviving spouse must be provided with a qualified preretirement survivor annuity ("QPSA"), which must provide the surviving spouse with a benefit that is not less than the benefit that would have been provided under the survivor portion of a QJSA.

The participant and his or her spouse may waive the right to a QJSA and QPSA provided certain requirements are satisfied. In general, these conditions include providing the participant with a written explanation of the terms and conditions of the survivor annuity, the right to make, and the effect of, a waiver of the annuity, the rights of the spouse to waive the survivor annuity, and the right of the participant to revoke the waiver. In addition, the spouse must provide a written consent to the waiver, witnessed by

[695] Thus, for example, a QJSA could consist of an annuity for the life of the participant, with a survivor annuity for the life of the spouse equal to 75 percent of the amount of the annuity payable during the joint lives of the participant and his or her spouse.

a plan representative or a notary public, which acknowledges the effect of the waiver.

Defined contribution plans other than money purchase pension plans are not required to provide a QJSA or QPSA if the participant does not elect an annuity as the form of payment, the surviving spouse is the beneficiary of the participant's entire vested account balance under the plan (unless the spouse consents to designation of another beneficiary),[696] and, with respect to the participant, the plan has not received a transfer from a plan to which the QJSA and QPSA requirements applied (or separately accounts for the transferred assets). In the case of a defined contribution plan subject to the QJSA and QPSA requirements, a QPSA means an annuity for the life of the surviving spouse that has an actuarial value of at least 50 percent of the participant's vested account balance as of the date of death.

### *Explanation of Provision*

The provision revises the minimum survivor annuity requirements to require that, at the election of the participant, benefits will be paid in the form of a "qualified optional survivor annuity." A qualified optional survivor annuity means an annuity for the life of the participant with a survivor annuity for the life of the spouse which is equal to the applicable percentage of the amount of the annuity that is: (1) payable during the joint lives of the participant and the spouse; and (2) the actuarial equivalent of a single annuity for the life of the participant.

If the survivor annuity provided by the QJSA under the plan is less than 75 percent of the annuity payable during the joint lives of the participant and spouse, the applicable percentage is 75 percent. If the survivor annuity provided by the QJSA under the plan is greater than or equal to 75 percent of the annuity payable during the joint lives of the participant and spouse, the applicable percentage is 50 percent. Thus, for example, if the survivor annuity provided by the QJSA under the plan is 50 percent, the survivor annuity provided under the qualified optional survivor annuity must be 75 percent.

The written explanation required to be provided to participants explaining the terms and conditions of the qualified joint and survivor annuity must also include the terms and conditions of the qualified optional survivor annuity.

Under the provision of the Act relating to plan amendments, a plan amendment made pursuant to a provision of the Act generally will not violate the anticutback rule if certain requirements are met. Thus, a plan is not treated as having decreased the accrued benefit of a participant solely by reason of the adoption of a plan amendment pursuant to the provision requiring that the plan offer a qualified optional survivor annuity. The elimination of a subsidized QJSA is not protected by the anticutback provision in the Act unless an equivalent or greater subsidy is retained in one of the forms offered under the plan as amended. For example, if a plan that offers a subsidized 50 percent QJSA is amended to pro-

[696] Waiver and election rules apply to the waiver of the right of the spouse to be the beneficiary under a defined contribution plan that is not required to provide a QJSA.

vide an unsubsidized 50 percent QJSA and an unsubsidized 75 percent joint and survivor annuity as its qualified optional survivor annuity, the replacement of the subsidized 50 percent QJSA with the unsubsidized 50 percent QJSA is not protected by the anticutback protection.

### *Effective Date*

The provision applies generally to plan years beginning after December 31, 2007. In the case of a plan maintained pursuant to one or more collective bargaining agreements, the provision applies to plan years beginning on or after the earlier of (1) the later of January 1, 2008, and the last date on which an applicable collective bargaining agreement terminates (without regard to extensions), and (2) January 1, 2009.

## TITLE XI—ADMINISTRATIVE PROVISIONS

### A. Updating of Employee Plans Compliance Resolution System (sec. 1101 of the Act)

#### *Present Law*

Tax-favored treatment is provided to various retirement savings arrangements that meet certain requirements under the Code, including qualified retirement plans and annuities (secs. 401(a) and 403(a)), tax-sheltered annuities (sec. 403(b)), simplified employee pensions ("SEPs") (sec. 408(k)), and SIMPLE IRAs (sec. 408(p)). The Internal Revenue Service ("IRS") has established the Employee Plans Compliance Resolution System ("EPCRS"), which is a comprehensive system of correction programs for sponsors of retirement plans and annuities that are intended to satisfy the requirements of section 401(a), section 403(a), section 403(b), section 408(k), or section 408(p), as applicable. The IRS has updated and expanded EPCRS several times.[697]

EPCRS permits employers to correct compliance failures and continue to provide their employees with retirement benefits on a tax-favored basis. EPCRS is based on the following general principles:

- Plans sponsors and administrators should be encouraged to establish administrative practices and procedures that ensure that plans are operated properly in accordance with applicable Code requirements;
- Plans sponsors and administrators should satisfy applicable plan document requirements;
- Plans sponsors and administrators should make voluntary and timely correction of any plan failures, whether involving discrimination in favor of highly compensated employees, plan operations, the terms of the plan document, or adoption of a plan by an ineligible employer; timely and efficient correction protects participating employees by providing them with their expected retirement benefits, including favorable tax treatment;
- Voluntary compliance is promoted by providing for limited fees for voluntary corrections approved by the Service, thereby reducing employers' uncertainty regarding their potential tax liability and participants' potential tax liability;
- Fees and sanctions should be graduated in a series of steps so that there is always an incentive to correct promptly;
- Sanctions for plan failures identified on audit should be reasonable in light of the nature, extent, and severity of the violation;

[697] See Rev. Proc. 2006–27, 2006–22 IRB 945.

- Administration of EPCRS should be consistent and uniform; and
- Sponsors should be able to rely on the availability of EPCRS in taking corrective actions to maintain the tax-favored status of their plans.

The components of EPCRS provide for self-correction, voluntary correction with IRS approval, and correction on audit. The Self-Correction Program ("SCP") generally permits a plan sponsor that has established compliance practices and procedures to correct certain insignificant failures at any time (including during an audit), and certain significant failures generally within a 2-year period, without payment of any fee or sanction. The Voluntary Correction Program ("VCP") permits an employer, at any time before an audit, to pay a limited fee and receive IRS approval of a correction. For a failure that is discovered on audit and corrected, the Audit Closing Agreement Program ("Audit CAP") provides for a sanction that bears a reasonable relationship to the nature, extent, and severity of the failure and that takes into account the extent to which correction occurred before audit.

### *Explanation of Provision*

The provision clarifies that the Secretary has the full authority to establish and implement EPCRS (or any successor program) and any other employee plans correction policies, including the authority to waive income, excise or other taxes to ensure that any tax, penalty or sanction is not excessive and bears a reasonable relationship to the nature, extent and severity of the failure.

Under the provision, the Secretary of the Treasury is directed to continue to update and improve EPCRS (or any successor program), giving special attention to (1) increasing the awareness and knowledge of small employers concerning the availability and use of EPCRS, (2) taking into account special concerns and circumstances that small employers face with respect to compliance and correction of compliance failures, (3) extending the duration of the self-correction period under SCP for significant compliance failures, (4) expanding the availability to correct insignificant compliance failures under SCP during audit, and (5) assuring that any tax, penalty, or sanction that is imposed by reason of a compliance failure is not excessive and bears a reasonable relationship to the nature, extent, and severity of the failure.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## B. Notice and Consent Period Regarding Distributions (sec. 1102 of the Act, sec. 417(a) of the Code, and sec. 205(c) of ERISA)

### *Present Law*

Notice and consent requirements apply to certain distributions from qualified retirement plans. These requirements relate to the content and timing of information that a plan must provide to a

participant prior to a distribution, and to whether the plan must obtain the participant's consent to the distribution. The nature and extent of the notice and consent requirements applicable to a distribution depend upon the value of the participant's vested accrued benefit and whether the joint and survivor annuity requirements apply to the participant.

If the present value of the participant's vested accrued benefit exceeds $5,000,[698] the plan may not distribute the participant's benefit without the written consent of the participant. The participant's consent to a distribution is not valid unless the participant has received from the plan a notice that contains a written explanation of (1) the material features and the relative values of the optional forms of benefit available under the plan, (2) the participant's right to defer the receipt of a distribution, or, as applicable, to have the distribution directly transferred to another retirement plan or individual retirement arrangement ("IRA"), and (3) the rules concerning taxation of a distribution. If the joint and survivor annuity requirements are applicable, this notice also must contain a written explanation of (1) the terms and conditions of the qualified joint and survivor annuity ("QJSA"), (2) the participant's right to make, and the effect of, an election to waive the QJSA, (3) the rights of the participant's spouse with respect to a participant's waiver of the QJSA, and (4) the right to make, and the effect of, a revocation of a waiver of the QJSA. The plan generally must provide this notice to the participant no less than 30 and no more than 90 days before the date distribution commences.[699]

### *Explanation of Provision*

Under the provision, a qualified retirement plan is required to provide the applicable distribution notice no less than 30 days and no more than 180 days before the date distribution commences. The Secretary of the Treasury is directed to modify the applicable regulations to reflect the extension of the notice period to 180 days and to provide that the description of a participant's right, if any, to defer receipt of a distribution shall also describe the consequences of failing to defer such receipt.

### *Effective Date*

The provision and the modifications required to be made under the provision apply to years beginning after December 31, 2006. In the case of a description of the consequences of a participant's failure to defer receipt of a distribution that is made before the date 90 days after the date on which the Secretary of the Treasury makes modifications to the applicable regulations, the plan administrator is required to make a reasonable attempt to comply with the requirements of the provision.

---

[698] The portion of a participant's benefit that is attributable to amounts rolled over from another plan may be disregarded in determining the present value of the participant's vested accrued benefit.

[699] Code sec. 417(a)(6)(A); ERISA sec. 205(c)(7)(A); Treas. Reg. secs. 1.402(f)–1, 1.411(a)–11(c), and 1.417(e)–1(b).

## C. Pension Plan Reporting Simplification (sec. 1103 of the Act)

### *Present Law*

The plan administrator of a pension plan generally must file an annual return with the Secretary of the Treasury, an annual report with the Secretary of Labor, and certain information with the Pension Benefit Guaranty Corporation ("PBGC"). Form 5500, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 with the Department of Labor.

The Form 5500 series consists of 2 different forms: Form 5500 and Form 5500–EZ. Form 5500 is the more comprehensive of the forms and requires the most detailed financial information. The plan administrator of a "one-participant plan" generally may file Form 5500–EZ. For this purpose, a plan is a one-participant plan if: (1) the only participants in the plan are the sole owner of a business that maintains the plan (and such owner's spouse), or partners in a partnership that maintains the plan (and such partners' spouses);[700] (2) the plan is not aggregated with another plan in order to satisfy the minimum coverage requirements of section 410(b); (3) the plan does not provide benefits to anyone other than the sole owner of the business (or the sole owner and spouse) or the partners in the business (or the partners and spouses); (4) the employer is not a member of a related group of employers; and (5) the employer does not use the services of leased employees. In addition, the plan administrator of a one-participant plan is not required to file a return if the plan does not have an accumulated funding deficiency and the total value of the plan assets as of the end of the plan year and all prior plan years beginning on or after January 1, 1994, does not exceed $100,000.

With respect to a plan that does not satisfy the eligibility requirements for Form 5500–EZ, the characteristics and the size of the plan determine the amount of detailed financial information that the plan administrator must provide on Form 5500. If the plan has more than 100 participants at the beginning of the plan year, the plan administrator generally must provide more information.

### *Explanation of Provision*

The Secretary of the Treasury is directed to modify the annual return filing requirements with respect to a one-participant plan to provide that if the total value of the plan assets of such a plan as of the end of the plan year does not exceed $250,000, the plan administrator is not required to file a return. In addition, the Secretary of the Treasury and the Secretary of Labor are directed to provide simplified reporting requirements for plan years beginning after December 31, 2006, for certain plans with fewer than 25 participants.

---

[700] Under Department of Labor regulations, certain business owners and their spouses are not treated as employees. 29 C.F.R. sec. 2510.3–3(c) (2006). Thus, plans covering only such individuals are not subject to ERISA.

### *Effective Date*

The provision relating to one-participant retirement plans is effective for plan years beginning on or after January 1, 2007. The provision relating to simplified reporting for plans with fewer than 25 participants is effective on the date of enactment (August 17, 2006).

## D. Voluntary Early Retirement Incentive and Employment Retention Plans Maintained by Local Educational Agencies and Other Entities (sec. 1104 of the Act, secs. 457(e)(11) and 457(f) of the Code, sec. 3(2)(B) of ERISA, and sec. 4(l)(1) of the ADEA)

### *Present Law*

#### *Eligible deferred compensation plans of State and local governments and tax-exempt employers*

A "section 457 plan" is an eligible deferred compensation plan of a State or local government or tax-exempt employer that meets certain requirements. For example, the amount that can be deferred annually under section 457 cannot exceed a certain dollar limit ($14,000 for 2005). Amounts deferred under a section 457 plan are generally includible in gross income when paid or made available (or, in the case of governmental section 457 plans, when paid). Subject to certain exceptions, amounts deferred under a plan that does not comply with section 457 (an "ineligible plan") are includible in income when the amounts are not subject to a substantial risk of forfeiture. Section 457 does not apply to any bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan. Additionally, section 457 does not apply to qualified retirement plans or qualified governmental excess benefit plans that provide benefits in excess of those that are provided under a qualified retirement plan maintained by the governmental employer.

#### *ERISA*

ERISA provides rules governing the operation of most employee benefit plans. The rules to which a plan is subject depend on whether the plan is an employee welfare benefit plan or an employee pension benefit plan. For example, employee pension benefit plans are subject to reporting and disclosure requirements, participation and vesting requirements, funding requirements, and fiduciary provisions. Employee welfare benefit plans are not subject to all of these requirements. Governmental plans are exempt from ERISA.

#### *Age Discrimination in Employment Act*

The Age Discrimination in Employment Act ("ADEA") generally prohibits discrimination in employment because of age. However, certain defined benefit pension plans may lawfully provide payments that constitute the subsidized portion of an early retirement

benefit or social security supplements pursuant to ADEA,[701] and employers may lawfully provide a voluntary early retirement incentive plan that is consistent with the purposes of ADEA.[702]

### *Explanation of Provision*

#### *Early retirement incentive plans of local educational agencies and education associations*

*In general*

The provision addresses the treatment of certain voluntary early retirement incentive plans under section 457, ERISA, and ADEA.

*Code section 457*

Under the provision, special rules apply under section 457 to a voluntary early retirement incentive plan that is maintained by a local educational agency or a tax-exempt education association which principally represents employees of one or more such agencies and that makes payments or supplements as an early retirement benefit, a retirement-type subsidy, or a social security supplement in coordination with a defined benefit pension plan maintained by a State or local government or by such an association. Such a voluntary early retirement incentive plan is treated as a bona fide severance plan for purposes of section 457, and therefore is not subject to the limits under section 457, to the extent the payments or supplements could otherwise be provided under the defined benefit pension plan. For purposes of the provision, the payments or supplements that could otherwise be provided under the defined benefit pension plan are to be determined by applying the accrual and vesting rules for defined benefit pension plans.[703]

*ERISA*

Under the provision, voluntary early retirement incentive plans (as described above) are treated as welfare benefit plans for purposes of ERISA (other than governmental plans that are exempt from ERISA).

*ADEA*

The provision also addresses the treatment under ADEA of voluntary early retirement incentive plans that are maintained by local educational agencies and tax-exempt education associations which principally represent employees of one or more such agencies, and that make payments or supplements that constitute the subsidized portion of an early retirement benefit or a social security supplement and that are made in coordination with a defined benefit pension plan maintained by a State or local government or by such an association. For purposes of ADEA, such a plan is treated as part of the defined benefit pension plan and the payments or supplements under the plan are not severance pay that may be subject to certain deductions under ADEA.

---

[701] See ADEA sec. 4(l)(1).

[702] See ADEA sec. 4(f)(2).

[703] The accrual and vesting rules have the effect of limiting the social security supplements and early retirement benefits that may be provided under a defined benefit pension plan; however, government plans are exempt from these rules.

### *Employment retention plans of local educational agencies and education associations*

The provision addresses the treatment of certain employment retention plans under section 457 and ERISA. The provision applies to employment retention plans that are maintained by local educational agencies or tax-exempt education associations which principally represent employees of one or more such agencies and that provide compensation to an employee (payable on termination of employment) for purposes of retaining the services of the employee or rewarding the employee for service with educational agencies or associations.

Under the provision, special tax treatment applies to the portion of an employment retention plan that provides benefits that do not exceed twice the applicable annual dollar limit on deferrals under section 457 ($14,000 for 2005). The provision provides an exception from the rules under section 457 for ineligible plans with respect to such portion of an employment retention plan. This exception applies for years preceding the year in which benefits under the employment retention plan are paid or otherwise made available to the employee. In addition, such portion of an employment retention plan is not treated as providing for the deferral of compensation for tax purposes.

Under the provision, an employment retention plan is also treated as a welfare benefit plan for purposes of ERISA (other than a governmental plan that is exempt from ERISA).

### *Effective Date*

The provision is generally effective on the date of enactment (August 17, 2006). The amendments to section 457 apply to taxable years ending after the date of enactment. The amendments to ERISA apply to plan years ending after the date of enactment. Nothing in the provision alters or affects the construction of the Code, ERISA, or ADEA as applied to any plan, arrangement, or conduct to which the provision does not apply.

## E. No Reduction in Unemployment Compensation as a Result of Pension Rollovers (sec. 1105 of the Act and sec. 3304(a)(15) of the Code)

### *Present Law*

Under present law, unemployment compensation payable by a State to an individual generally is reduced by the amount of retirement benefits received by the individual. Distributions from certain employer-sponsored retirement plans or IRAs that are transferred to a similar retirement plan or IRA ("rollover distributions") generally are not includible in income. Some States currently reduce the amount of an individual's unemployment compensation by the amount of a rollover distribution.

### *Explanation of Provision*

The provision amends the Code so that the reduction of unemployment compensation payable to an individual by reason of the

receipt of retirement benefits does not apply in the case of a rollover distribution.

### *Effective Date*

The provision is effective for weeks beginning on or after the date of enactment (August 17, 2006).

## F. Revocation of Election Relating to Treatment as Multiemployer Plan (sec. 1106 of the Act, sec. 3(37) of ERISA, and sec. 414(f) of the Code)

### *Present Law*

A multiemployer plan means a plan (1) to which more than one employer is required to contribute; (2) which is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer; and (3) which satisfies such other requirements as the Secretary of Labor may prescribe.[704] Present law provides that within one year after the date of enactment of the Multiemployer Pension Plan Amendments Act of 1980, a multiemployer plan could irrevocably elect for the plan not to be treated as a multiemployer plan if certain requirements were satisfied.

### *Explanation of Provision*

The provision allows multiemployer plans to revoke an existing election not to treat the plan as a multiemployer plan if, for each of the three plan years prior to the date of enactment, the plan would have been a multiemployer plan, but for the extension in place. The revocation must be pursuant to procedures prescribed by the PBGC.

The provision also provides that a plan to which more than one employer is required to contribute which is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer (collectively the "criteria") may, pursuant to procedures prescribed by the PBGC, elect to be a multiemployer plan if (1) for each of the three plan years prior to the date of enactment, the plan has met the criteria; (2) substantially all of the plan's employer contributions for each of those plan years were made or required to be made by organizations that were tax-exempt; and (3) the plan was established prior to September 2, 1974. Such election is also available in the case of a plan sponsored by an organization that was established in Chicago, Illinois, on August 12, 1881, and is described in Code section 501(c)(5). There is no inference that a plan that makes an election to be a multiemployer plan was not a multiemployer plan prior to the date of enactment or would not be a multiemployer plan without regard to the election.

An election made under the provision is effective beginning with the first plan year ending after date of enactment and is irrevocable. A plan that elects to be a multiemployer plan under the provision will cease to be a multiemployer plan as of the plan year

[704] ERISA sec. 3(36); Code sec. 414(f).

beginning immediately after the first plan year for which the majority of its employer contributions were made or required to be made by organizations that were not tax-exempt. Elections and revocations under the provision must be made within one year after the date of enactment.

Not later than 30 days before an election is made, the plan administrator must provide notice of the pending election to each plan participant and beneficiary, each labor organization representing such participants or beneficiaries, and to each employer that has an obligation to contribute to the plan. Such notice must include the principal differences between the guarantee programs and benefit restrictions for single employer and multiemployer plans. The Secretary of Labor must prescribe a model notice within 180 days after date of enactment. The plan administrator's failure to provide the notice is treated as a failure to file an annual report. Thus, an ERISA penalty of $1,100 per day applies.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## G. Provisions Relating to Plan Amendments (sec. 1107 of the Act)

### *Present Law*

Present law provides a remedial amendment period during which, under certain circumstances, a plan may be amended retroactively in order to comply with the qualification requirements.[705] In general, plan amendments to reflect changes in the law generally must be made by the time prescribed by law for filing the income tax return of the employer for the employer's taxable year in which the change in law occurs. The Secretary of the Treasury may extend the time by which plan amendments need to be made.

The Code and ERISA provide that, in general, accrued benefits cannot be reduced by a plan amendment.[706] This prohibition on the reduction of accrued benefits is commonly referred to as the "anticutback rule."

### *Explanation of Provision*

The provision permits certain plan amendments made pursuant to the changes in the Act, or regulations issued thereunder, to be retroactively effective. If a plan amendment meets the requirements of the provision, then the plan will be treated as being operated in accordance with its terms and the amendment will not violate the anticutback rule. In order for this treatment to apply, the plan must be operated as if the plan amendment were in effect, and the amendment is required to be made on or before the last day of the first plan year beginning on or after January 1, 2009 (2011 in the case of a governmental plan). If the amendment is required to be made to retain qualified status as a result of the

[705] Sec. 401(b).
[706] Code sec. 411(d)(6); ERISA sec. 204(g).

changes in the law (or regulations), the amendment is required to be made retroactively effective as of the date on which the change became effective with respect to the plan and the plan is required to be operated in compliance until the amendment is made. Amendments that are not required to retain qualified status but that are made pursuant to the changes made by the Act (or applicable regulations) may be made retroactively effective as of the first day the amendment is effective.

A plan amendment will not be considered to be pursuant to the Act (or applicable regulations) if it has an effective date before the effective date of the provision under the Act (or regulations) to which it relates. Similarly, the provision does not provide relief from the anticutback rule for periods prior to the effective date of the relevant provision (or regulations) or the plan amendment. The Secretary of the Treasury is authorized to provide exceptions to the relief from the prohibition on reductions in accrued benefits. It is intended that the Secretary will not permit inappropriate reductions in contributions or benefits that are not directly related to the provisions under the Act.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

# TITLE XII—PROVISIONS RELATING TO EXEMPT ORGANIZATIONS

## A. Charitable Giving Incentives

### 1. Tax-free distributions from individual retirement plans for charitable purposes (sec. 1201 of the Act and secs. 408, 6034, 6104, and 6652 of the Code)

#### *Present Law*

***In general***

If an amount withdrawn from a traditional individual retirement arrangement ("IRA") or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions.

***Charitable contributions***

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3), to certain veterans' organizations, fraternal societies, and cemetery companies,[707] or to a Federal, State, or local governmental entity for exclusively public purposes.[708] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[709]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[710]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate, among other things, that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution

[707] Secs. 170(c)(3)–(5).
[708] Sec. 170(c)(1).
[709] Secs. 170(b) and (e).
[710] Sec. 170(a).

of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[711] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services may be deductible as a charitable contribution.[712]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limits may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2006 is $150,500 ($75,250 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The 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 on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an

[711] Sec. 170(f)(8).
[712] Sec. 6115.

interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.[713] Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.[714] For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

### *IRA rules*

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59½ are subject to an additional 10-percent early withdrawal tax, unless an exception applies. Under present law, minimum distributions are required to be made from tax-favored retirement arrangements, including IRAs. Minimum required distributions from a traditional IRA must generally begin by the April 1 of the calendar year following the year in which the IRA owner attains age 70½.[715]

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;[716] (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as

[713] Secs. 170(f), 2055(e)(2), and 2522(c)(2).

[714] Sec. 170(f)(2).

[715] Minimum distribution rules also apply in the case of distributions after the death of a traditional or Roth IRA owner.

[716] Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

a single contribution, and all conversion contributions during the year are treated as a single contribution.

Distributions from an IRA (other than a Roth IRA) are generally subject to withholding unless the individual elects not to have withholding apply.[717] Elections not to have withholding apply are to be made in the time and manner prescribed by the Secretary.

### *Split-interest trust filing requirements*

Split-interest trusts, including charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, are required to file an annual information return (Form 1041A).[718] Trusts that are not split-interest trusts but that claim a charitable deduction for amounts permanently set aside for a charitable purpose[719] also are required to file Form 1041A. The returns are required to be made publicly available.[720] A trust that is required to distribute all trust net income currently to trust beneficiaries in a taxable year is exempt from this return requirement for such taxable year. A failure to file the required return may result in a penalty on the trust of $10 a day for as long as the failure continues, up to a maximum of $5,000 per return.

In addition, split-interest trusts are required to file annually Form 5227.[721] Form 5227 requires disclosure of information regarding a trust's noncharitable beneficiaries. The penalty for failure to file this return is calculated based on the amount of tax owed. A split-interest trust generally is not subject to tax and therefore, in general, a penalty may not be imposed for the failure to file Form 5227. Form 5227 is not required to be made publicly available.

## *Explanation of Provision*

### *Qualified charitable distributions from IRAs*

The provision provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions.[722] The exclusion may not exceed $100,000 per taxpayer per taxable year. Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The present-law rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions. Qualified charitable distributions are taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the provision. An IRA does not fail to qualify as an IRA merely because qualified charitable distributions have been made from the IRA. It is intended that the Sec-

[717] Sec. 3405.
[718] Sec. 6034. This requirement applies to all split-interest trusts described in section 4947(a)(2).
[719] Sec. 642(c).
[720] Sec. 6104(b).
[721] Sec. 6011; Treas. Reg. sec. 53.6011–1(d).
[722] The provision does not apply to distributions from employer-sponsored retirement plans, including SIMPLE IRAs and simplified employee pensions ("SEPs").

retary will prescribe rules under which IRA owners are deemed to elect out of withholding if they designate that a distribution is intended to be a qualified charitable distribution.

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund (as defined in section 4966(d)(2)). Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70½.

The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution.

If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the provision) and thus is eligible for qualified charitable distribution treatment. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the provision) if the aggregate balance of all IRAs having the same owner were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are to be made to reflect the amount treated as a qualified charitable distribution under the special rule.

Distributions that are excluded from gross income by reason of the provision are not taken into account in determining the deduction for charitable contributions under section 170.

The provision does not apply to distributions made in taxable years beginning after December 31, 2007.

### *Qualified charitable distribution examples*

The following examples illustrate the determination of the portion of an IRA distribution that is a qualified charitable distribution. In each example, it is assumed that the requirements for qualified charitable distribution treatment are otherwise met (e.g., the applicable age requirement and the requirement that contributions are otherwise deductible) and that no other IRA distributions occur during the year.

*Example 1.*—Individual A has a traditional IRA with a balance of $100,000, consisting solely of deductible contributions and earnings. Individual A has no other IRA. The entire IRA balance is distributed in a distribution to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund). Under present law, the entire distribution of $100,000 would be includible in Individual A's income. Accordingly, under the provision, the entire distribution of $100,000 is a qualified charitable distribution. As a result, no amount is included in Individual A's income as a result of the distribution and the distribution is not taken into account in deter-

mining the amount of Individual A's charitable deduction for the year.

*Example 2.*—Individual B has a traditional IRA with a balance of $100,000, consisting of $20,000 of nondeductible contributions and $80,000 of deductible contributions and earnings. Individual B has no other IRA. In a distribution to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund), $80,000 is distributed from the IRA. Under present law, a portion of the distribution from the IRA would be treated as a nontaxable return of nondeductible contributions. The nontaxable portion of the distribution would be $16,000, determined by multiplying the amount of the distribution ($80,000) by the ratio of the nondeductible contributions to the account balance ($20,000/$100,000). Accordingly, under present law, $64,000 of the distribution ($80,000 minus $16,000) would be includible in Individual B's income.

Under the provision, notwithstanding the present-law tax treatment of IRA distributions, the distribution is treated as consisting of income first, up to the total amount that would be includible in gross income (but for the provision) if all amounts were distributed from all IRAs otherwise taken into account in determining the amount of IRA distributions. The total amount that would be includible in income if all amounts were distributed from the IRA is $80,000. Accordingly, under the provision, the entire $80,000 distributed to the charitable organization is treated as includible in income (before application of the provision) and is a qualified charitable distribution. As a result, no amount is included in Individual B's income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual B's charitable deduction for the year. In addition, for purposes of determining the tax treatment of other distributions from the IRA, $20,000 of the amount remaining in the IRA is treated as Individual B's nondeductible contributions (i.e., not subject to tax upon distribution).

### *Split-interest trust filing requirements*

The provision increases the penalty on split-interest trusts for failure to file a return and for failure to include any of the information required to be shown on such return and to show the correct information. The penalty is $20 for each day the failure continues up to $10,000 for any one return. In the case of a split-interest trust with gross income in excess of $250,000, the penalty is $100 for each day the failure continues up to a maximum of $50,000. In addition, if a person (meaning any officer, director, trustee, employee, or other individual who is under a duty to file the return or include required information)[723] knowingly failed to file the return or include required information, then that person is personally liable for such a penalty, which would be imposed in addition to the penalty that is paid by the organization. Information regarding beneficiaries that are not charitable organizations as described in section 170(c) is exempt from the requirement to make information publicly available. In addition, the provision repeals the present-

[723] Sec. 6652(c)(4)(C).

law exception to the filing requirement for split-interest trusts that are required in a taxable year to distribute all net income currently to beneficiaries. Such exception remains available to trusts other than split-interest trusts that are otherwise subject to the filing requirement.

### *Effective Date*

The provision relating to qualified charitable distributions is effective for distributions made in taxable years beginning after December 31, 2005. The provision relating to information returns of split-interest trusts is effective for returns for taxable years beginning after December 31, 2006.

## 2. Extension of modification of charitable deduction for contributions of food inventory (sec. 1202 of the Act and sec. 170 of the Code)

### *Present Law*

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis (sec. 170(e)(3)). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income (sec. 170(b)(2)). To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory (Treas. Reg. sec. 1.170A–4A(c)(3)). Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valu-

ation of food inventory has been the subject of disputes between taxpayers and the IRS.[724]

Under the Katrina Emergency Tax Relief Act of 2005, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for certain donations made after August 28, 2005, and before January 1, 2006, of food inventory. For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other entity that is not a C corporation) from which contributions of "apparently wholesome food" are made. "Apparently wholesome food" is defined as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

### *Explanation of Provision*

The provision extends the provision enacted as part of the Katrina Emergency Tax Relief Act of 2005. As under such Act, under the provision, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for donations of food inventory. For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other non C corporation) from which contributions of apparently wholesome food are made. For example, as under the Katrina Emergency Tax Relief Act of 2005, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the taxpayer's interest in the S corporation, but not the taxpayer's interest in the partnership.[725]

Under the provision, the enhanced deduction for food is available only for food that qualifies as "apparently wholesome food." "Apparently wholesome food" is defined as it is defined under the Katrina Emergency Tax Relief Act of 2005.

---

[724] *Lucky Stores Inc.* v. *Commissioner*, 105 T.C. 420 (1995) (holding that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted).

[725] The 10 percent limitation does not affect the application of the generally applicable percentage limitations. For example, if 10 percent of a sole proprietor's net income from the proprietor's trade or business was greater than 50 percent of the proprietor's contribution base, the available deduction for the taxable year (with respect to contributions to public charities) would be 50 percent of the proprietor's contribution base. Consistent with present law, such contributions may be carried forward because they exceed the 50 percent limitation. Contributions of food inventory by a taxpayer that is not a C corporation that exceed the 10 percent limitation but not the 50 percent limitation could not be carried forward.

The provision does not apply to contributions made after December 31, 2007.

### *Effective Date*

The provision is effective for contributions made after December 31, 2005.

## 3. Basis adjustment to stock of S corporation contributing property (sec. 1203 of the Act and sec. 1367 of the Code)

### *Present Law*

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.[726] A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[727]

### *Explanation of Provision*

The provision provides that the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation will be equal to the shareholder's pro rata share of the adjusted basis of the contributed property.[728]

Thus, for example, assume an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of $200 and a fair market value of $500. The shareholder will be treated as having made a $500 charitable contribution (or a lesser amount if the special rules of section 170(e) apply), and will reduce the basis of the S corporation stock by $200.[729]

The provision does not apply to contributions made in taxable years beginning after December 31, 2007.

### *Effective Date*

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

## 4. Extension of modification of charitable deduction for contributions of book inventory (sec. 1204 of the Act and sec. 170 of the Code)

### *Present Law*

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

---

[726] Sec. 1366(a)(1)(A).

[727] Sec. 1367(a)(2)(B).

[728] See Rev. Rul. 96–11 (1996–1 C.B. 140) for a rule reaching a similar result in the case of charitable contributions made by a partnership.

[729] This example assumes that basis of the S corporation stock (before reduction) is at least $200.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis (sec. 170(e)(3)). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income (sec. 170(b)(2)). To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory (Treas. Reg. sec. 1.170A–4A(c)(3)). Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis.

The Katrina Emergency Tax Relief Act of 2005 extended the present-law enhanced deduction for C corporations to certain qualified book contributions made after August 28, 2005, and before January 1, 2006. For such purposes, a qualified book contribution means a charitable contribution of books to a public school that provides elementary education or secondary education (kindergarten through grade 12) and that is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The enhanced deduction under the Katrina Emergency Tax Relief Act of 2005 is not allowed unless the donee organization certifies in writing that the contributed books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs.

### *Explanation of Provision*

The provision extends the provision enacted as part of the Katrina Emergency Tax Relief Act of 2005. As under such Act, an enhanced deduction for C corporations for qualified book contributions is allowed. The provision does not apply to contributions made after December 31, 2007.

### *Effective Date*

The provision is effective for contributions made after December 31, 2005.

## 5. Modification of tax treatment of certain payments under existing arrangements to controlling exempt organizations (sec. 1205 of the Act and secs. 512 and 6033 of the Code)

### *Present Law*

In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations. However, section 512(b)(13) generally treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization. In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

Under present law, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includable in the latter organization's unrelated business income and are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt).

### *Explanation of Provision*

The provision provides that the general rule of section 512(b)(13), which includes interest, rent, annuity, or royalty payments made by a controlled entity to the controlling tax-exempt organization in the latter organization's unrelated business income to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity, applies only to the portion of payments received or accrued in a taxable year that exceeds the amount of the specified payment that would have been paid or accrued if such payment had been determined under the principles of section 482. Thus, if a payment of rent by a controlled subsidiary to its tax-exempt parent organization exceeds fair market value, the excess amount of such payment over fair market value (as determined in accordance with section 482) is included in the parent organization's unrelated business income, to the extent that such excess reduced the net unrelated income (or increased any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt). In addition, the provision imposes a 20-percent penalty on the larger of such excess determined without regard to

any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements. The provision applies only to payments made pursuant to a binding written contract in effect on the date of enactment (or renewal of such a contract on substantially similar terms). This part of the provision does not apply to payments received or accrued after December 31, 2007. It is intended that there should be further study of such arrangements in light of the provision before any determination about whether to extend or expand the provision is made.

The provision requires that a tax-exempt organization that receives interest, rent, annuity, or royalty payments from a controlled entity report such payments on its annual information return as well as any loans made to any controlled entity and any transfers between such organization and a controlled entity.

The provision provides that, not later than January 1, 2009, the Secretary shall submit to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives a report on the effectiveness of the Internal Revenue Service in administering the provision and on the extent to which payments by controlled entities to the controlling exempt organization meet the requirements of section 482 of the Code. Such report shall include the results of any audit of any controlling organization or controlled entity and recommendations relating to the tax treatment of payments from controlled entities to controlling organizations.

### *Effective Date*

The provision related to payments to controlling organizations applies to payments received or accrued after December 31, 2005. The provision relating to reporting is effective for returns the due date (determined without regard to extensions) of which is after the date of enactment (August 17, 2006). The provision relating to a report by the Secretary is effective on the date of enactment.

## 6. Encouragement of contributions of capital gain real property made for conservation purposes (sec. 1206 of the Act and sec. 170 of the Code)

### *Present Law*

#### *Charitable contributions generally*

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.[730]

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating or capital loss carrybacks. For individuals, the amount deductible is a percentage of the tax-

[730] Secs. 170, 2055, and 2522, respectively.

payer's contribution base, which is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base. Cash contributions to private foundations and certain other organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while also either retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration. Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property, and qualified conservation contributions.

### *Capital gain property*

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 capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of 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 capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer'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. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

### *Qualified conservation contributions*

Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation pur-

poses. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryover rules of other charitable contributions of capital gain property.

## *Explanation of Provision*

### *In general*

Under the provision, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in section 170(b)(1)(A) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions.

Individuals are allowed to carryover any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years.

For example, assume an individual with a contribution base of $100 makes a qualified conservation contribution of property with a fair market value of $80 and makes other charitable contributions subject to the 50-percent limitation of $60. The individual is allowed a deduction of $50 in the current taxable year for the nonconservation contributions (50 percent of the $100 contribution base) and is allowed to carryover the excess $10 for up to 5 years. No current deduction is allowed for the qualified conservation contribution, but the entire $80 qualified conservation contribution may be carried forward for up to 15 years.

### *Farmers and ranchers*

#### *Individuals*

In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the above example, if the individual is a qualified farmer or rancher, in addition to the $50 deduction for non-conservation contributions, an additional $50 for the qualified conservation contribution is allowed and $30 may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.

*Corporations*

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.

*Requirement that land be available for agriculture or livestock production*

As an additional condition of eligibility for the 100 percent limitation, with respect to any contribution of property in agriculture or livestock production, or that is available for such production, by a qualified farmer or rancher, the qualified real property interest must include a restriction that the property remain generally available for such production. (There is no requirement as to any specific use in agriculture or farming, or necessarily that the property be used for such purposes, merely that the property remain available for such purposes.) Such additional condition does not apply to contributions made after December 31, 2005, and on or before the date of enactment.

*Definition*

A qualified farmer or rancher means a taxpayer whose gross income from the trade or business of farming (within the meaning of section 2032A(e)(5)) is greater than 50 percent of the taxpayer's gross income for the taxable year.

The provision does not apply to contributions made in taxable years beginning after December 31, 2007.

### *Effective Date*

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

## 7. Excise taxes exemption for blood collector organizations (sec. 1207 of the Act and secs. 4041, 4221, 4253, 4483, 6416, and 7701 of the Code)

### *Present Law*

#### *American National Red Cross*

The American National Red Cross ("Red Cross") is a Congressionally chartered corporation. It is responsible for giving aid to members of the U.S. Armed Forces, to disaster victims in the United States and abroad to help people prevent, prepare for, and

respond to emergencies.[731] The Red Cross is responsible for over half of the nation's blood supply and blood products.

*Exemption from certain retail and manufacturers excise taxes*

The Code permits the Secretary to exempt from excise tax certain articles and services to be purchased for the exclusive use of the United States (sec. 4293). This authority is conditioned upon the Secretary determining (1) that the imposition of such taxes will cause substantial burden or expense which can be avoided by granting tax exemption and (2) that full benefit of such exemption, if granted, will accrue to the United States.

On April 18, 1979, the Secretary exercised this authority to exempt, with limited exceptions, the Red Cross from the taxes imposed by chapters 31 and 32 of the Code with respect to articles sold to the Red Cross for its exclusive use.[732] An exemption is also authorized from the taxes imposed with respect to tires and inner tubes if such tire or inner tube is sold by any person on or in connection with the sale of any article to the American National Red Cross, for its exclusive use.[733] No exemption is provided from the gas guzzler tax (sec. 4064), and the taxes imposed on aviation fuel, on fuel used on inland waterways (sec. 4042), and on coal (sec. 4121).[734] The exemption is subject to registration requirements for tax-free sales contained in Treasury regulations. Credit and refund of tax is subject to the requirements set forth in section 6416 relating to the exemption for taxable articles sold for the exclusive use of State and local governments.

*Exemption from heavy highway motor vehicle use tax*

An annual use tax is imposed on highway motor vehicles, at the rates below (sec. 4481).

| | |
|---|---|
| Under 55,000 pounds | No tax. |
| 55,000–75,000 pounds | $100 plus $22 per 1,000 pounds over 55,000. |
| Over 75,000 pounds | $550. |

The Code provides that the Secretary may authorize exemption from the heavy highway vehicle use tax as to the use by the United States of any particular highway motor vehicle or class of highway motor vehicles if the Secretary determines that the imposition of such tax with respect to such use will cause substantial burden or expense which can be avoided by granting tax exemption and that the full benefit of such exemption, if granted will accrue to the United States (sec. 4483(b)). The IRS has ruled that the Red Cross comes within the term "United States" for purposes of the exemp-

[731] *See* 36 U.S.C. sec. 300102.

[732] Department of the Treasury, *Notice-Manufacturers and Retailers Excise Taxes—Exemption from Tax of Sales of Certain Articles to the American Red Cross*, 44 F.R. 23407, 1979–1 C.B. 478 (1979). At the time the notice was issued the following taxes were covered in Chapters 31 and 32: special fuels, automotive and related items (motor vehicles, tires and tubes, petroleum products, coal, and recreational equipment (sporting goods and firearms).

[733] Under present law, there is no longer a tax on inner tubes.

[734] Department of the Treasury, *Notice-Manufacturers and Retailers Excise Taxes—Exemption from Tax of Sales of Certain Articles to the American Red Cross*, 44 F.R. 23407, 1979–1 C.B. 478, at 479 (1979). The Treasury notice also exempts the Red Cross from tax on aircraft tires and tubes, however, present law currently limits the tax to highway vehicle tires (sec. 4071(a)).

tion from the heavy highway motor vehicle use tax (Rev. Rul. 76–510).

*Exemption from communications excise tax*

The Code imposes a three-percent tax on amounts paid for local telephone service; toll telephone service and teletypewriter exchange service (sec. 4251). These taxes do not apply to amounts paid for services furnished to the Red Cross (sec. 4253(c)).

### *Certain other tax-free sales*

*Exemption from certain manufacturer and retail sale excise taxes*

The following sales generally are exempt from certain manufacturer and retail sale excise taxes: (1) for use by the purchaser for further manufacture, or for resale to a second purchaser in further manufacture; (2) for export or for resale to a second purchaser for export; (3) for use by the purchaser as supplies for vessels or aircraft; (4) to a State or local government for the exclusive use of a State or local government; and (5) to a nonprofit educational organization for its exclusive use (sec. 4221). The exemption generally applies to manufacturers taxes imposed by chapter 32 of the Code (the gas guzzlers tax, and the taxes imposed on tires, certain vaccines, and recreational equipment) and the tax on retail sales of heavy trucks and trailers.[735]

The manufacturers excise taxes on coal (sec. 4121), on gasoline, diesel fuel, and kerosene (sec. 4081) are not covered by the exemption. The exemption for a sale to a State or local government for their exclusive use and the exemption for sales to a nonprofit educational organization does not apply to the gas guzzlers tax, and the tax on vaccines. In addition, the exemption of sales for use as supplies for vessels and aircraft does not apply to the vaccine tax.

*Exempt sales of special fuels*

A retail excise tax is imposed on special motor fuels, including propane, compressed natural gas, and certain alcohol mixtures (sec. 4041). Section 4041 also serves as a back-up tax for diesel fuel or kerosene that was not subject to the manufacturers taxes under section 4081 (other than the Leaking Underground Storage Tank Trust Fund tax) if such fuel is delivered into the fuel supply tank of a diesel-powered highway vehicle or train.[736] No tax is imposed on these fuels for nontaxable uses, including fuel: (1) sold for use or used as supplies for vessels or aircraft, (2) sold for the exclusive use of any State, any political subdivision of a State, or the District of Columbia or used by such entity as fuel, (3) sold for export, or for shipment to a possession of the United States and is actually exported or shipped, (4) sold to a nonprofit educational organization for its exclusive use, or used by such entity as fuel (sec. 4041(g)).

[735] The tax imposed by subchapter A of chapter 31 (relating to luxury passenger vehicles) is also exempt pursuant to this provision, however, this tax expired on December 31, 2002. (sec. 4001(g).)

[736] For example, tax is imposed on the delivery of any of the following into the fuel supply tank of a diesel powered highway vehicle or train of any dyed diesel or dyed kerosene for other than a nontaxable use; any undyed diesel fuel or undyed kerosene on which a credit or refund.

***Credits and refunds***

*In general*

A credit or refund is allowed for overpayment of manufacturers or retail excise taxes (sec. 6416). Overpayments include (1) certain uses and resales, (2) price adjustments, and (3) further manufacture.

*Specified uses and resales*

The special fuel taxes, the retail tax on heavy trucks and trailers, and any of the manufacturers excise taxes paid on any article will be a deemed overpayment subject to credit or refund if sold for certain specified uses (sec. 6416(b)(2)). These uses are (1) export, (2) used or sold for use as supplies for vessels or aircraft, (3) sold to a State or local government for the exclusive use of a State or local government, (4) sold to a nonprofit educational organization for its exclusive use; (5) taxable tires sold to any person for use in connection with a qualified bus, or (6) the case of gasoline used or sold for use in the production of a special fuel. Certain exceptions apply in that this deemed overpayment rule does not apply to the taxes imposed by sections 4041 and 4081 on diesel fuel and kerosene, and the coal taxes (sec. 4121). Additionally, the deemed overpayment rule does not apply to the gas guzzler tax in the case of an article sold to a state or local government for its exclusive use or sold to an educational organization for its exclusive use.

*Special rule for tires sold in connection with other articles*

If the tax imposed on tires (sec. 4071) has been paid with respect to the sale of any tire by the manufacturer, producer, or importer, and such tire is sold by any person in connection with the sale of any other article, such tax will be deemed an overpayment by person if such other article (1) is an automobile bus chassis or an automobile bus body, or (2) is by any person exported, sold to a State or local government for exclusive use of a State or local government, sold to a nonprofit educational organization for its exclusive use, or used or sold for use as supplies for vessels or aircraft (sec. 6416(b)(4)).

*Gasoline used for exempt purposes*

If gasoline is sold to any person for certain specified purposes, the Secretary is required to pay (without interest) to such person an amount equal to the product of the number of gallons of gasoline so sold multiplied by the rate at which tax was imposed on such gasoline under section 4081 (sec. 6421(c)). Under this provision, the specified purposes are (1) for export or for resale to a second purchaser for export; (2) for use by the purchaser as supplies for vessels or aircraft; (3) to a State or local government for exclusive use of a State or local government; and (4) to a nonprofit educational organization for its exclusive use (sec. 4221(a), 6421(c)).

*Diesel fuel or kerosene used in a nontaxable use*

If diesel fuel or kerosene, upon which tax has been imposed is used by any person in a nontaxable use, the Code authorizes the Secretary to pay (without interest) an amount equal to the aggre-

gate amount of tax imposed on such fuel (sec. 6427(l)). Nontaxable uses include any exemption from the tax imposed by section 4041(a) (except prior taxation).

### *Explanation of Provision*

The provision exempts qualified blood collector organizations from certain retail and manufacturers excise taxes to the extent such items are for the exclusive use of such an organization for the distribution or collection of blood. A qualified blood collector organization means an organization that is (1) described in section 501(c)(3) and exempt from tax under section 501(a), (2) primarily engaged in the activity of the collection of blood, (3) registered with the Secretary for purposes of excise tax exemptions, and (4) registered by the Food and Drug Administration to collect blood.

Under the provision, qualified blood collector organizations are exempt from the communications excise tax as provided by Treasury regulations. The provision also provides an exemption from the special fuels tax, and certain taxes imposed by chapter 32 and subchapter A and C of chapter 31 of the Code (i.e., the retail excise tax on heavy trucks and trailers, and the manufacturers excise taxes on tires).[737] The provision also makes conforming amendments to allow for the credit or refund of these taxes and any tax paid on gasoline for the exclusive use of the blood collector organization. The provision also permits a refund of tax for diesel fuel or kerosene used by a qualified blood collector organization. Finally, the provision provides an exemption from the heavy vehicle use tax of a "qualified blood collector vehicle" by a qualified blood collector organization. A "qualified blood collector vehicle" means a vehicle at least 80 percent of the use of which during the prior taxable period was by a qualified blood collector organization in the collection, storage, or transportation of blood. A special rule is provided for the first taxable period a vehicle is placed in service by the qualified blood collector organization. For the first taxable period a vehicle is placed in service by the organization, the vehicle will be treated as a "qualified blood collector vehicle" for that period if the organization certifies that it reasonably expects that at least 80 percent of the use of the vehicle during such taxable period will be by the organization in the collection, storage, or transportation of blood. Such certification is to be provided to the Secretary on such forms and in such manner as the Secretary may require.

It is expected that the excise tax exemptions of the Red Cross will be reexamined in conjunction with a review of its charter.

### *Effective Date*

Generally, the provision is effective on January 1, 2007. The exemption from the heavy vehicle use tax is effective for taxable periods beginning on or after July 1, 2007.

---

[737] Such organizations are also exempt from the expired retail excise tax on luxury passenger vehicles. No exemption is provided from the gas guzzler tax (sec. 4064), the taxes imposed on fuel used on inland waterways (sec. 4042), on coal (sec. 4121), and on recreational equipment (sport fishing equipment, bows, arrow components, and firearms).

## B. Reforming Exempt Organizations

### 1. Require reporting on certain acquisitions of interests in insurance contracts in which certain exempt organizations hold an interest; require Treasury Study (sec. 1211 of the Act and new sec. 6050V of the Code)

#### *Present Law*

***Amounts received under a life insurance contract***

Amounts received under a life insurance contract paid by reason of the death of the insured are not includible in gross income for Federal tax purposes.[738] No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract (inside buildup).[739]

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income to the extent that the amounts distributed exceed the taxpayer's investment in the contract (i.e., basis). Such distributions generally are treated first as a tax-free recovery of basis, and then as income.[740]

***Transfers for value***

A limitation on the exclusion for amounts received under a life insurance contract is provided in the case of transfers for value. If a life insurance contract (or an interest in the contract) is transferred for valuable consideration, the amount excluded from income by reason of the death of the insured is limited to the actual value of the consideration plus the premiums and other amounts subsequently paid by the acquiror of the contract.[741]

***Tax treatment of charitable organizations and donors***

Present law generally provides tax-exempt status for charitable, educational and certain other organizations, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and which meet certain other requirements.[742] Governmental entities, including some educational organizations, are exempt from tax on income under other tax rules providing that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof.[743]

---

[738] Sec. 101(a).

[739] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract. Sec. 7702.

[740] Sec. 72(e). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59½ and in certain other circumstances. Secs. 72(e) and (v). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums. Sec. 7702A.

[741] Section 101(a)(2). The transfer-for-value rule does not apply, however, in the case of a transfer in which the life insurance contract (or interest in the contract) transferred has a basis in the hands of the transferee that is determined by reference to the transferor's basis. Similarly, the transfer-for-value rule generally does not apply if the transfer is between certain parties (specifically, if the transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer).

[742] Section 501(c)(3).

[743] Section 115.

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity for exclusively public purposes.[744]

### *State-law insurable interest rules*

State laws generally provide that the owner of a life insurance contract must have an insurable interest in the insured person when the life insurance contract is issued. State laws vary as to the insurable interest of a charitable organization in the life of any individual. Some State laws provide that a charitable organization meeting the requirements of section 501(c)(3) of the Code is treated as having an insurable interest in the life of any donor,[745] or, in other States, in the life of any individual who consents (whether or not the individual is a donor).[746] Other States' insurable interest rules permit the purchase of a life insurance contract even though the person paying the consideration has no insurable interest in the life of the person insured if a charitable, benevolent, educational or religious institution is designated irrevocably as the beneficiary.[747]

### *Transactions involving charities and non-charities acquiring life insurance*

Recently, there has been an increase in transactions involving the acquisition of life insurance contracts using arrangements in which both exempt organizations, primarily charities, and private investors have an interest in the contract.[748] The exempt organization has an insurable interest in the insured individuals, either because they are donors, because they consent, or otherwise under applicable State insurable interest rules. Private investors provide capital used to fund the purchase of the life insurance contracts, sometimes together with annuity contracts. Both the private investors and the charity have an interest in the contracts, directly or indirectly, through the use of trusts, partnerships, or other arrangements for sharing the rights to the contracts. Both the charity and the private investors receive cash amounts in connection with the investment in the contracts while the life insurance is in force or as the insured individuals die.

## *Explanation of Provision*

The provision includes a temporary reporting requirement with respect to the acquisition of interests in certain life insurance contracts by certain exempt organizations, together with a Treasury study.

---

[744] Section 170.

[745] See, e.g., Mass. Gen. Laws Ann. ch. 175, sec. 123A(2) (West 2005); Iowa Code Ann. sec. 511.39 (West 2004) ("a person who, when purchasing a life insurance policy, makes a donation to the charitable organization or makes the charitable organization the beneficiary of all or a part of the proceeds of the policy . . .).

[746] See, e.g., Cal. Ins. Code sec. 10110.1(f) (West 2005); 40 Pa. Cons. Stat. Ann. sec. 40–512 (2004); Fla. Stat. Ann. sec. 27.404 (2) (2004); Mich. Comp. Laws Ann. sec. 500.2212 (West 2004).

[747] Or. Rev. Stat. sec. 743.030 (2003); Del. Code Ann. Tit. 18, sec. 2705(a) (2004).

[748] Davis, Wendy, "Death-Pool Donations," Trusts and Estates, May 2004, 55; Francis, Theo, "Tax May Thwart Investment Plans Enlisting Charities," Wall St. J., Feb. 8, 2005, A–10.

The provision provides that, for reportable acquisitions occurring after the date of enactment and on or before the date two years from the date of enactment, an applicable exempt organization that makes a reportable acquisition is required to file an information return. The information return is to contain the name, address, and taxpayer identification number of the organization and of the issuer of the applicable insurance contract, and such other information as the Secretary of the Treasury prescribes. It is intended that the Treasury Department may require the reporting of other information relevant to the study required under the provision. The report is to be in the form prescribed by the Treasury Secretary and is required to be filed at the time established by the Treasury Secretary. It is intended that the Treasury Department may require the report to be filed within a certain period after the reportable acquisition takes place in order to gather information in a timely manner that is relevant to the study required under the provision.

For this purpose, a reportable acquisition means the acquisition by an applicable exempt organization of a direct or indirect interest in a contract that the applicable exempt organization knows or has reason to know is an applicable insurance contract, if such acquisition is a part of a structured transaction involving a pool of such contracts.

An applicable insurance contract means any life insurance, annuity, or endowment contract with respect to which both an applicable exempt organization and a person other than an applicable exempt organization have directly or indirectly held an interest in the contract (whether or not at the same time). Exceptions apply under this definition. First, the term does not apply if each person (other than an applicable exempt organization) with a direct or indirect interest in the contract has an insurable interest in the insured independent of any interest of the exempt organization in the contract. Second, the term does not apply if the sole interest in the contract of the applicable exempt organization or each person other than the applicable exempt organization is as a named beneficiary. Third, the term does not apply if the sole interest in the contract of each person other than the applicable exempt organization is either (1) as a beneficiary of a trust holding an interest in the contract, but only if the person's designation as such a beneficiary was made without consideration and solely on a purely gratuitous basis, or (2) as a trustee who holds an interest in the contract in a fiduciary capacity solely for the benefit of applicable exempt organizations or of persons otherwise meeting one of the first two exceptions.

An applicable exempt organization is any organization described in section 170(c), 168(h)(2)(A)(iv), 2055(a), or 2522(a). Thus, for example, an applicable exempt organization generally includes an organization that is exempt from Federal income tax by reason of being described in section 501(c)(3) (including one organized outside the United States), a government or political subdivision of a government, and an Indian tribal government.

Under the provision, penalties apply for failure to file the return.

The reporting requirement terminates with respect to reportable acquisitions occurring after the date that is two years after the date of enactment.

The provision requires the Treasury Secretary to undertake a study on the use by tax-exempt organizations of applicable insurance contracts for the purpose of sharing the benefits of the organization's insurable interest in insured individuals under such contracts with investors, and whether such activities are consistent with the tax-exempt status of the organizations. The study may, for example, address whether certain such arrangements are or may be used to improperly shelter income from tax, and whether they should be listed transactions within the meaning of Treasury Regulation section 1.6011–4(b)(2). No later than 30 months after the date of enactment, the Treasury Secretary is required to report on the study to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives.

### *Effective Date*

The reporting provision is effective for acquisitions of contracts after the date of enactment (August 17, 2006). The study provision is effective on the date of enactment.

## 2. Increase in penalty excise taxes relating to public charities, social welfare organizations, and private foundations (sec. 1212 of the Act and secs. 4941, 4942, 4943, 4944, 4945, and 4958 of the Code)

### *Present Law*

#### *Public charities and social welfare organizations*

The Code imposes excise taxes on excess benefit transactions between disqualified persons (as defined in section 4958(f)) and charitable organizations (other than private foundations) or social welfare organizations (as described in section 501(c)(4)).[749] An excess benefit transaction generally is a transaction in which an economic benefit is provided by a charitable or social welfare organization directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

The excess benefit tax is imposed on the disqualified person and, in certain cases, on the organization manager, but is not imposed on the exempt organization. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected. A tax of 10 percent of the excess benefit (not to exceed $10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.[750] If more than one person is

[749] Sec. 4958. The excess benefit transaction tax commonly is referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status.

[750] Sec. 4958(d)(2). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

liable for the tax on disqualified persons or on management, all such persons are jointly and severally liable for the tax.[751]

### *Private foundations*

#### *Self-dealing by private foundations*

Excise taxes are imposed on acts of self-dealing between a disqualified person (as defined in section 4946) and a private foundation.[752] In general, self-dealing transactions are any direct or indirect: (1) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (2) lending of money or other extension of credit between a private foundation and a disqualified person; (3) the furnishing of goods, services, or facilities between a private foundation and a disqualified person; (4) the payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; (5) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the private foundation; and (6) certain payments of money or property to a government official.[753] Certain exceptions apply.[754]

An initial tax of five percent of the amount involved with respect to an act of self-dealing is imposed on any disqualified person (other than a foundation manager acting only as such) who participates in the act of self-dealing. If such a tax is imposed, a 2.5-percent tax of the amount involved is imposed on a foundation manager who participated in the act of self-dealing knowing it was such an act (and such participation was not willful and was due to reasonable cause) up to $10,000 per act. Such initial taxes may not be abated.[755] Such initial taxes are imposed for each year in the taxable period, which begins on the date the act of self-dealing occurs and ends on the earliest of the date of mailing of a notice of deficiency for the tax, the date on which the tax is assessed, or the date on which correction of the act of self-dealing is completed. A government official (as defined in section 4946(c)) is subject to such initial tax only if the official participates in the act of self-dealing knowing it is such an act. If the act of self-dealing is not corrected, a tax of 200 percent of the amount involved is imposed on the disqualified person and a tax of 50 percent of the amount involved (up to $10,000 per act) is imposed on a foundation manager who refused to agree to correcting the act of self-dealing. Such additional taxes are subject to abatement.[756]

#### *Tax on failure to distribute income*

Private nonoperating foundations are required to pay out a minimum amount each year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization's exempt purposes, including reasonable and necessary administrative expenses.[757] Failure to pay out the minimum amount results in an initial excise tax on the foundation

[751] Sec. 4958(d)(1).
[752] Sec. 4941.
[753] Sec. 4941(d)(1).
[754] Sec. 4941(d)(2).
[755] Sec. 4962(b).
[756] Sec. 4961.
[757] Sec. 4942(g)(1)(A).

of 15 percent of the undistributed amount. An additional tax of 100 percent of the undistributed amount applies if an initial tax is imposed and the required distributions have not been made by the end of the applicable taxable period.[758] A foundation may include as a qualifying distribution the salaries, occupancy expenses, travel costs, and other reasonable and necessary administrative expenses that the foundation incurs in operating a grant program. A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's exempt purposes and certain amounts set aside for exempt purposes.[759] Private operating foundations are not subject to the payout requirements.

*Tax on excess business holdings*

Private foundations are subject to tax on excess business holdings.[760] In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership ("profits interest" is substituted for "voting stock" and "capital interest" for "nonvoting stock") and to other unincorporated enterprises (by substituting "beneficial interest" for "voting stock"). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.[761] This five-year period may be extended an additional five years in limited circumstances.[762] The excess business holdings rules do not apply to holdings in a functionally related business or to holdings in a trade or business at least 95 percent of the gross income of which is derived from passive sources.[763]

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation's applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

---

[758] Sec. 4942(a) and (b). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[759] Sec. 4942(g)(1)(B) and 4942(g)(2). In general, an organization is permitted to adjust the distributable amount in those cases where distributions during the five preceding years have exceeded the payout requirements. Sec. 4942(i).

[760] Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[761] Sec. 4943(c)(6).

[762] Sec. 4943(c)(7).

[763] Sec. 4943(d)(3).

*Tax on jeopardizing investments*

Private foundations and foundation managers are subject to tax on investments that jeopardize the foundation's charitable purpose.[764] In general, an initial tax of five percent of the amount of the investment applies to the foundation and to foundation managers who participated in the making of the investment knowing that it jeopardized the carrying out of the foundation's exempt purposes. The initial tax on foundation managers may not exceed $5,000 per investment. If the investment is not removed from jeopardy (e.g., sold or otherwise disposed of), an additional tax of 25 percent of the amount of the investment is imposed on the foundation and five percent of the amount of the investment on a foundation manager who refused to agree to removing the investment from jeopardy. The additional tax on foundation managers may not exceed $10,000 per investment. An investment, the primary purpose of which is to accomplish a charitable purpose and no significant purpose of which is the production of income or the appreciation of property, is not considered a jeopardizing investment.[765]

*Tax on taxable expenditures*

Certain expenditures of private foundations are subject to tax.[766] In general, taxable expenditures are expenses: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility[767] with respect to the grant; or (5) for any non-charitable purpose. For each taxable expenditure, a tax is imposed on the foundation of 10 percent of the amount of the expenditure, and an additional tax of 100 percent is imposed on the foundation if the expenditure is not corrected. A tax of 2.5 percent of the expenditure (up to $5,000) also is imposed on a foundation manager who agrees to making a taxable expenditure knowing that it is a taxable expenditure. An additional tax of 50 percent of the amount of the expenditure (up to $10,000) is imposed on a foundation manager who refuses to agree to correction of such expenditure.

## *Explanation of Provision*

### *Self-dealing and excess benefit transaction initial taxes and dollar limitations*

For acts of self-dealing involving a private foundation and a disqualified person, the provision increases the initial tax on the self-dealer from five percent of the amount involved to 10 percent of the amount involved. The provision increases the initial tax on foundation managers from 2.5 percent of the amount involved to five per-

[764] Sec. 4944. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.
[765] Sec. 4944(c).
[766] Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.
[767] In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

cent of the amount involved and increases the dollar limitation on the amount of the initial and additional taxes on foundation managers per act of self-dealing from $10,000 per act to $20,000 per act. Similarly, the provision doubles the dollar limitation on organization managers of public charities and social welfare organizations for participation in excess benefit transactions from $10,000 per transaction to $20,000 per transaction.

***Failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures***

The provision doubles the amounts of the initial taxes and the dollar limitations on foundation managers with respect to the private foundation excise taxes on the failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures.

Specifically, for the failure to distribute income, the initial tax on the foundation is increased from 15 percent of the undistributed amount to 30 percent of the undistributed amount.

For excess business holdings, the initial tax on excess business holdings is increased from five percent of the value of such holdings to 10 percent of such value.

For jeopardizing investments, the initial tax of five percent of the amount of the investment that is imposed on the foundation and on foundation managers is increased to 10 percent of the amount of the investment. The dollar limitation on the initial tax on foundation managers of $5,000 per investment is increased to $10,000 and the dollar limitation on the additional tax on foundation managers of $10,000 per investment is increased to $20,000.

For taxable expenditures, the initial tax on the foundation is increased from 10 percent of the amount of the expenditure to 20 percent, the initial tax on the foundation manager is increased from 2.5 percent of the amount of the expenditure to five percent, the dollar limitation on the initial tax on foundation managers is increased from $5,000 to $10,000, and the dollar limitation on the additional tax on foundation managers is increased from $10,000 to $20,000.

### *Effective Date*

The provision is effective for taxable years beginning after the date of enactment (August 17, 2006).

## 3. Reform of charitable contributions of certain easements in registered historic districts and reduction of deduction for portion of qualified conservation contribution attributable to rehabilitation credit (sec. 1213 of the Act and sec. 170 of the Code)

### *Present Law*

***In general***

Present law provides special rules that apply to charitable deductions of qualified conservation contributions, which include con-

servation easements and facade easements.[768] Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property.[769] Accordingly, qualified conservation contributions are contributions of partial interests that are eligible for a fair market value charitable deduction.

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property.[770] Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations.

Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.[771]

In general, no deduction is available if the property may be put to a use that is inconsistent with the conservation purpose of the gift.[772] A contribution is not deductible if it accomplishes a permitted conservation purpose while also destroying other significant conservation interests.[773]

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach an appraisal summary to the tax return.[774] Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[775] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer

[768] Sec. 170(h).
[769] Sec. 170(f)(3).
[770] Charitable contributions of interests that constitute the taxpayer's entire interest in the property are not regarded as qualified real property interests within the meaning of section 170(h), but instead are subject to the general rules applicable to charitable contributions of entire interests of the taxpayer (i.e., generally are deductible at fair market value, without regard to satisfaction of the requirements of section 170(h)).
[771] Sec. 170(h)(4)(A).
[772] Treas. Reg. sec. 1.170A–14(e)(2).
[773] Treas. Reg. sec. 1.170A–14(e)(2).
[774] Sec. 170(f)(11)(C).
[775] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[776]

### *Valuation*

The value of a conservation restriction granted in perpetuity generally is determined under the "before and after approach." Such approach provides that the fair market value of the restriction is equal to the difference (if any) between the fair market value of the property the restriction encumbers before the restriction is granted and the fair market value of the encumbered property after the restriction is granted.[777]

If the granting of a perpetual restriction has the effect of increasing the value of any other property owned by the donor or a related person, the amount of the charitable deduction for the conservation contribution is to be reduced by the amount of the increase in the value of the other property.[778] In addition, the donor is to reduce the amount of the charitable deduction by the amount of financial or economic benefits that the donor or a related person receives or can reasonably be expected to receive as a result of the contribution.[779] If such benefits are greater than those that will inure to the general public from the transfer, no deduction is allowed.[780] In those instances where the grant of a conservation restriction has no material effect on the value of the property, or serves to enhance, rather than reduce, the value of the property, no deduction is allowed.[781]

### *Preservation of a certified historic structure*

A certified historic structure means any building, structure, or land which is (i) listed in the National Register, or (ii) located in a registered historic district (as defined in section 47(c)(3)(B)) and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.[782] For this purpose, a structure means any structure, whether or not it is depreciable, and, accordingly, easements on private residences may qualify.[783] If restrictions to preserve a building or land area within a registered historic district permit future development on the site, a deduction will be allowed only if the terms of the restrictions require that such development conform with appropriate local, State, or Federal standards for construction or rehabilitation within the district.[784]

The IRS and the courts have held that a facade easement may constitute a qualifying conservation contribution.[785] In general, a facade easement is a restriction the purpose of which is to preserve

---

[776] Treas. Reg. sec. 1.170A–13(c)(3).
[777] Treas. Reg. sec. 1.170A–14(h)(3).
[778] Treas. Reg. sec. 1.170A–14(h)(3)(i).
[779] *Id.*
[780] *Id.*
[781] Treas. Reg. sec. 1.170A–14(h)(3)(ii).
[782] Sec. 170(h)(4)(B).
[783] Treas. Reg. sec. 1.170A–14(d)(5)(iii).
[784] Treas. Reg. sec. 1.170A–14(d)(5)(i).
[785] *Hillborn* v. *Commissioner,* 85 T.C. 677 (1985) (holding the fair market value of a facade donation generally is determined by applying the "before and after" valuation approach); Richmond v. U.S., 699 F. Supp. 578 (E.D. La. 1988); Priv. Ltr. Rul. 199933029 (May 24, 1999) (ruling that a preservation and conservation easement relating to the facade and certain interior portions of a fraternity house was a qualified conservation contribution).

certain architectural, historic, and cultural features of the facade, or front, of a building. The terms of a facade easement might permit the property owner to make alterations to the facade of the structure if the owner obtains consent from the qualified organization that holds the easement.

### *Rehabilitation credit*

In general, present law allows as part of the general business credit an investment tax credit.[786] The amount of the investment tax credit includes the amount of a rehabilitation credit.[787] The rehabilitation credit for any taxable year is the sum of 10 percent of the qualified rehabilitation expenditures with respect to any qualified rehabilitated building other than a certified historic structure and 20 percent of the qualified rehabilitation expenditures with respect to any certified historic structure.[788] In general, a qualified rehabilitated building is a depreciable building (and its structural components) if the building has been substantially rehabilitated, was placed in service before the beginning of the rehabilitation, and (except for a certified historic structure) in the rehabilitation process a certain percentage of the existing internal and external walls and internal structural framework are retained in place as internal and external walls and internal structural framework. A qualified rehabilitation expenditure is, in general, an amount properly chargeable to a capital account (i) for depreciable property that is nonresidential real property, residential rental property, real property that has a class life of more than 12.5 years, or an addition or improvement to any such property and (ii) in connection with the rehabilitation of a qualified rehabilitation building.

## *Explanation of Provision*

### *Easements in registered historic districts*

The provision revises the rules for qualified conservation contributions with respect to property for which a charitable deduction is allowable under section 170(h)(4)(B)(ii) by reason of a property's location in a registered historic district. Under the provision, a charitable deduction is not allowable with respect to a structure or land area located in such a district (by reason of the structure or land area's location in such a district). A charitable deduction is allowable with respect to buildings (as is the case under present law) but the qualified real property interest that relates to the exterior of the building must preserve the entire exterior of the building, including the space above the building, the sides, the rear, and the front of the building. In addition, such qualified real property interest must provide that no portion of the exterior of the building may be changed in a manner inconsistent with the historical character of such exterior.

For any contribution relating to a registered historic district made after the date of enactment of the provision, taxpayers must include with the return for the taxable year of the contribution a qualified appraisal of the qualified real property interest (irrespec-

[786] Sec. 38(b)(1).
[787] Sec. 46.
[788] Sec. 47(a).

tive of the claimed value of such interest) and attach the appraisal with the taxpayer's return, photographs of the entire exterior of the building,[789] and descriptions of all current restrictions on development of the building, including, for example, zoning laws, ordinances, neighborhood association rules, restrictive covenants, and other similar restrictions. Failure to obtain and attach an appraisal or to include the required information results in disallowance of the deduction. In addition, the donor and the donee must enter into a written agreement certifying, under penalty of perjury, that the donee is a qualified organization, with a purpose of environmental protection, land conservation, open space preservation, or historic preservation, and that the donee has the resources to manage and enforce the restriction and a commitment to do so.

Taxpayers claiming a deduction for a qualified conservation contribution with respect to the exterior of a building located in a registered historic district in excess of $10,000 must pay a $500 fee to the Internal Revenue Service or the deduction is not allowed. Amounts paid are required to be dedicated to Internal Revenue Service enforcement of qualified conservation contributions.

### *Reduction of deduction to take account of rehabilitation credit*

The provision provides that in the case of any qualified conservation contribution, the amount of the deduction is reduced by an amount that bears the same ratio to the fair market value of the contribution as the sum of the rehabilitation credits under section 47 for the preceding five taxable years with respect to a building that is part of the contribution bears to the fair market value of the building on the date of the contribution. For example, if a taxpayer makes a qualified conservation contribution with respect to a building, and such taxpayer has claimed a rehabilitation credit with respect to such building in any of the five taxable years preceding the year in which the contribution is claimed, the taxpayer must reduce the amount of the contribution. If the aggregate amount of credits claimed by the taxpayer within such five year period is $100,000, and the fair market value of the building with respect to which the contribution is made is $1,000,000, the taxpayer must reduce the amount of the deduction by 10 percent (or 100,000 over 1,000,000).

## *Effective Date*

The provisions relating to deductions for contributions relating to structures and land areas and to the rehabilitation credit are effective for contributions made after the date of enactment (August 17, 2006). The provision relating to a filing fee is effective for contributions made 180 days after the date of enactment. The rest of the provision is effective for contributions made after July 25, 2006.

---

[789] Photographs of the entire exterior of the building are required to the extent practicable. For example, if the building is a skyscraper, aerial photographs of the roof would not be required, but photographs sufficient to establish the existing exterior still must be submitted.

### 4. Charitable contributions of taxidermy property (sec. 1214 of the Act and sec. 170 of the Code)

#### *Present Law*

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity.[790] The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[791] In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor,[792] though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. 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 capital gain property are subject to different percentage limitations (i.e., limitations based on the donor's income) than other contributions of property.

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;[793] (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of taxidermy are subject to the tangible personal property rule (number (2) above). For example, for appre-

---

[790] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

[791] Secs. 170(b) and (e).

[792] Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

[793] For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis. Secs. 170(e)(3), 170(e)(4), and 170(e)(6).

ciated taxidermy, if the property is used to further the donee's exempt purpose, the deduction is fair market value. But if the property is not used to further the donee's exempt purpose, the deduction is the donor's basis. If the taxidermy is depreciated, i.e., the value is less than the taxpayer's basis in such property, taxpayers generally deduct the fair market value of such contributions, regardless of whether the property is used for exempt or unrelated purposes by the donee.

### *Explanation of Provision*

In general, the provision provides that the amount allowed as a deduction for charitable contributions of taxidermy property that is contributed by the person who prepared, stuffed, or mounted the property (or by any person who paid or incurred the cost of such preparation, stuffing, or mounting) is the lesser of the taxpayer's basis in the property or the fair market value of the property. Specifically, a taxpayer that makes such a charitable contribution of taxidermy property for a use related to the donee's exempt purpose or function must, in determining the amount of the deduction, reduce the fair market value of the property by the amount of gain that would have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of the contribution). Taxidermy property is defined as any work of art that is the reproduction or preservation of an animal in whole or in part, is prepared, stuffed or mounted for purposes of recreating one or more characteristics of such animal, and contains a part of the body of the dead animal.

For purposes of determining a taxpayer's basis in taxidermy property that is contributed by the person who prepared, stuffed, or mounted the property (or by any person who paid or incurred the cost of such preparation, stuffing, or mounting), the provision provides a special rule that the basis of such property may include only the cost of the preparing, stuffing, or mounting. For purposes of the special rule, it is intended that only the direct costs of the preparing, stuffing, or mounting may be included in basis. Indirect costs, not included in the basis, include the costs of transportation relating to any aspect of the taxidermy or the hunting of the animal, and the direct or indirect costs relating to the hunting or killing of an animal (including the cost of equipment and the costs of preparing an animal carcass for taxidermy).

### *Effective Date*

The provision is effective for contributions made after July 25, 2006.

## 5. Recapture of tax benefit for charitable contributions of exempt use property not used for an exempt use (sec. 1215 of the Act and secs. 170, 6050L, and new sec. 6720B of the Code)

### *Present Law*

### *Deductibility of charitable contributions*

*In general*

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity.[794] The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer[795]. In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor,[796] though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

*Contributions of property*

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. 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 capital gain property are subject to different percentage limitations (i.e., limitations based on the donor's income) than other contributions of property.

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;[797] (2) tan-

---

[794] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

[795] Secs. 170(b) and (e).

[796] Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

[797] For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis. Secs. 170(e)(4), and 170(e)(6).

gible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

*Substantiation*

No charitable deduction is allowed for any contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization.[798] Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution (and a good faith estimate of the value of any such goods or services).

In general, if the total charitable deduction claimed for non-cash property is more than $500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.[799] C corporations (other than personal service corporations and closely-held corporations) are required to file Form 8283 only if the deduction claimed is more than $5,000. Information required on the Form 8283 includes, among other things, a description of the property, the appraised fair market value (if an appraisal is required), the donor's basis in the property, how the donor acquired the property, a declaration by the appraiser regarding the appraiser's general qualifications, an acknowledgement by the donee that it is eligible to receive deductible contributions, and an indication by the donee whether the property is intended for an unrelated use.

Taxpayers are required to obtain a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.[800] Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[801] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[802] In the case of contributions of art valued at more than $20,000 and other contributions of more than $500,000, taxpayers are required to attach the appraisal to the tax return. Taxpayers may request a Statement of Value from the Internal Revenue Service in order to substantiate the value of art with an appraised value of $50,000 or

[798] Sec. 170(f)(8).
[799] Sec. 170(f)(11).
[800] *Id.*
[801] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.
[802] Treas. Reg. sec. 1.170A–13(c)(3). Sec. 170(f)(11)(E).

more for income, estate, or gift tax purposes.[803] The fee for such a Statement is $2,500 for one, two, or three items of art plus $250 for each additional item.

If a donee organization sells, exchanges, or otherwise disposes of contributed property with a claimed value of more than $5,000 (other than publicly traded securities) within two years of the property's receipt, the donee is required to file a return (Form 8282) with the Secretary, and to furnish a copy of the return to the donor, showing the name, address, and taxpayer identification number of the donor, a description of the property, the date of the contribution, the amount received on the disposition, and the date of the disposition.[804]

### *Explanation of Provision*

In general, the provision recovers the tax benefit for charitable contributions of tangible personal property with respect to which a fair market value deduction is claimed and which is not used for exempt purposes. The provision applies to appreciated tangible personal property that is identified by the donee organization, for example on the Form 8283, as for a use related to the purpose or function constituting the donee's basis for tax exemption, and for which a deduction of more than $5,000 is claimed ("applicable property").[805]

Under the provision, if a donee organization disposes of applicable property within three years of the contribution of the property, the donor is subject to an adjustment of the tax benefit.[806] If the disposition occurs in the tax year of the donor in which the contribution is made, the donor's deduction generally is basis and not fair market value. If the disposition occurs in a subsequent year, the donor must include as ordinary income for its taxable year in which the disposition occurs an amount equal to the excess (if any) of (i) the amount of the deduction previously claimed by the donor as a charitable contribution with respect to such property, over (ii) the donor's basis in such property at the time of the contribution.

There is no adjustment of the tax benefit if the donee organization makes a certification to the Secretary, by written statement signed under penalties of perjury by an officer of the organization. The statement must either (1) certify that the use of the property by the donee was related to the purpose or function constituting the basis for the donee's exemption, and describe how the property was used and how such use furthered such purpose or function; or (2) state the intended use of the property by the donee at the time of the contribution and certify that such use became impossible or infeasible to implement. The organization must furnish a copy of the certification to the donor (for example, as part of the Form 8282, a copy of which is supplied to the donor).

A penalty of $10,000 applies to a person that identifies applicable property as having a use that is related to a purpose or function

[803] Rev. Proc. 96–15, 1996–1 C.B. 627.

[804] Sec. 6050L(a)(1).

[805] Present law rules continue to apply to any contribution of exempt use property for which a deduction of $5,000 or less is claimed.

[806] The disposition proceeds are regarded as relevant to a determination of fair market value.

constituting the basis for the donee's exemption knowing that it is not intended for such a use.[807]

### *Reporting of exempt use property contributions*

The provision modifies the present-law information return requirements that apply upon the disposition of contributed property by a charitable organization (Form 8282, sec. 6050L). The return requirement is extended to dispositions made within three years after receipt (from two years). The donee organization also must provide, in addition to the information already required to be provided on the return, a description of the donee's use of the property, a statement of whether use of the property was related to the purpose or function constituting the basis for the donee's exemption, and, if applicable, a certification of any such use (described above).

### *Effective Date*

The provision is effective for contributions made and returns filed after September 1, 2006, and with respect to the penalty, for identifications made after the date of enactment (August 17, 2006).

## 6. Limitation of deduction for charitable contributions of clothing and household items (sec. 1216 of the Act and sec. 170 of the Code)

### *Present Law*

### *In general*

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity.[808] The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[809] In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor,[810] though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

---

[807] Other present-law penalties also may apply, such as the penalty for aiding and abetting the understatement of tax liability under section 6701.

[808] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

[809] Secs. 170(b) and (e).

[810] Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

### *Contributions of property*

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. 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 capital gain property are subject to different percentage limitations than other contributions of property.

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;[811] (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of clothing and household items are subject to the tangible personal property rule (number (2) above). If such contributed property is appreciated property in the hands of the taxpayer, and is not used to further the donee's exempt purpose, the deduction is basis. In general, however, the value of clothing and household items is less than the taxpayer's basis in such property, with the result that taxpayers generally deduct the fair market value of such contributions, regardless of whether the property is used for exempt or unrelated purposes by the donee.

### *Substantiation*

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution. For a contribution of money, the donor generally must maintain one of the following: (1) a canceled check; (2) a receipt (or a letter or other written communication) from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution; or (3) in the absence of a canceled check or a receipt, other reliable written records showing the name of the donee, the date of the contribution, and the amount of the contribution. For a contribution of property other than money, the donor generally must maintain a receipt from the donee organization showing the name of the donee, the date and location of the contribution, and a detailed description (but not the value) of the property.[812] A donor of property other than money need not obtain a receipt, however, if circumstances make obtaining a receipt impracticable. Under such circumstances, the donor must maintain reli-

[811] For certain contributions of inventory and other property, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis. Secs. 170(e)(3), 170(e)(4), and 170(e)(6).

[812] Treas. Reg. sec. 1.170A–13(a).

able written records regarding the contribution. The required content of such a record varies depending upon factors such as the type and value of property contributed.[813]

In addition to the foregoing recordkeeping requirements, substantiation requirements apply in the case of charitable contributions with a value of $250 or more. No charitable deduction is allowed for any contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization. Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such goods or services.[814] In general, if the total charitable deduction claimed for non-cash property is more than $500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.[815] In general, taxpayers are required to obtain a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.

### *Explanation of Provision*

The provision provides that no deduction is allowed for a charitable contribution of clothing or household items unless the clothing or household item is in good used condition or better. The Secretary is authorized to deny by regulation a deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks and used undergarments. It is noted that the President's Advisory Panel on Federal Tax Reform and the staff of the Joint Committee on Taxation both have concluded that the fair market value-based deduction for contributions of clothing and household items present difficult tax administration issues, as determining the correct value of an item is a fact intensive, and thus also a resource intensive matter.[816] As recently reported by the IRS, the amount claimed as deductions in tax year 2003 for clothing and household items was more than $9 billion.[817] It is expected that the Secretary, in consultation with affected charities, will exercise assiduously the authority to disallow a deduction for some items of low value, consistent with the goals of improving tax administration and ensure that donated clothing and households items are of meaningful use to charitable organizations.

Under the provision, a deduction may be allowed for a charitable contribution of an item of clothing or a household item not in good used condition or better if the amount claimed for the item is more than $500 and the taxpayer includes with the taxpayer's return a qualified appraisal with respect to the property. Household items include furniture, furnishings, electronics, appliances, linens, and

---

[813] Treas. Reg. sec. 1.170A–13(b).

[814] Sec. 170(f)(8).

[815] Sec. 170(f)(11).

[816] See The President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System,* 78 (2005); Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* 288 (JCS–02–05), January 27, 2005.

[817] Internal Revenue Service, Statistics of Income Division, *Individual Noncash Charitable Contributions, 2003,* Figure A (Spring 2006).

other similar items. Food, paintings, antiques, and other objects of art, jewelry and gems, and collections are excluded from the provision.

### *Effective Date*

The provision is effective for contributions made after the date of enactment (August 17, 2006).

## 7. Modification of recordkeeping requirements for certain charitable contributions (sec. 1217 of the Act and sec. 170 of the Code)

### *Present Law*

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution. For a contribution of money, the donor generally must maintain one of the following: (1) a cancelled check; (2) a receipt (or a letter or other written communication) from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution; or (3) in the absence of a cancelled check or a receipt, other reliable written records showing the name of the donee, the date of the contribution, and the amount of the contribution. For a contribution of property other than money, the donor generally must maintain a receipt from the donee organization showing the name of the donee, the date and location of the contribution, and a detailed description (but not the value) of the property.[818] A donor of property other than money need not obtain a receipt, however, if circumstances make obtaining a receipt impracticable. Under such circumstances, the donor must maintain reliable written records regarding the contribution. The required content of such a record varies depending upon factors such as the type and value of property contributed.[819]

In addition to the foregoing recordkeeping requirements, substantiation requirements apply in the case of charitable contributions with a value of $250 or more. No charitable deduction is allowed for any contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization. Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such goods or services.[820] In general, if the total charitable deduction claimed for non-cash property is more than $500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.[821] In general, taxpayers are required to obtain a qualified appraisal

[818] Treas. Reg. sec. 1.170A–13(a).
[819] Treas. Reg. sec. 1.170A–13(b).
[820] Sec. 170(f)(8).
[821] Sec. 170(f)(11).

for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.

### *Explanation of Provision*

The provision more closely aligns the substantiation rules for money to the substantiation rules for property by providing that in the case of a charitable contribution of money, regardless of the amount, applicable recordkeeping requirements are satisfied only if the donor maintains as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. The recordkeeping requirements may not be satisfied by maintaining other written records. It is noted that currently, taxpayers are required to have a contemporaneous record of contributions of money, but that many taxpayers may not be aware of the requirement and do not keep a log of such contributions. The provision is intended to provide greater certainty, both to taxpayers and to the Secretary, in determining what may be deducted as a charitable contribution.

### *Effective Date*

The provision is effective for contributions made in taxable years beginning after the date of enactment (August 17, 2006).

## 8. Contributions of fractional interests in tangible personal property (sec. 1218 of the Act and secs. 170, 2055, and 2522 of the Code)

### *Present Law*

In general, a charitable deduction is not allowable for a contribution of a partial interest in property, such as an income interest, a remainder interest, or a right to use property.[822] A gift of an undivided portion of a donor's entire interest in property generally is not treated as a nondeductible gift of a partial interest in property.[823] For this purpose, an undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property.[824] A gift generally is treated as a gift of an undivided portion of a donor's entire interest in property if the donee is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property.[825]

A charitable contribution deduction generally is not allowable for a contribution of a future interest in tangible personal property.[826] For this purpose, a future interest is one "in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization which has

[822] Secs. 170(f)(3)(A) (income tax), 2055(e)(2) (estate tax), and 2522(c)(2) (gift tax).
[823] Sec. 170(f)(3)(B)(ii).
[824] Treas. Reg. sec. 1.170A–7(b)(1).
[825] Treas. Reg. sec. 1.170A–7(b)(1).
[826] Sec. 170(a)(3).

the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property."[827] Treasury regulations provide that section 170(a)(3), which generally denies a deduction for a contribution of a future interest in tangible personal property, "[has] no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during three months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than one year."[828]

### *Explanation of Provision*

In general, under present law and the provision a donor may take a deduction for a charitable contribution of a fractional interest in tangible personal property (such as an artwork), provided the donor satisfies the requirements for deductibility (including the requirements concerning contributions of partial interests and future interests in property), and in subsequent years make additional charitable contributions of interests in the same property.[829] Under the provision, the value of a donor's charitable deduction for the initial contribution of a fractional interest in an item of tangible personal property (or collection of such items) shall be determined as under current law (e.g., based upon the fair market value of the artwork at the time of the contribution of the fractional interest and considering whether the use of the artwork will be related to the donee's exempt purposes). For purposes of determining the deductible amount of each additional contribution of an interest (whether or not a fractional interest) in the same item of property, the fair market value of the item is the lesser of: (1) the value used for purposes of determining the charitable deduction for the initial fractional contribution; or (2) the fair market value of the item at the time of the subsequent contribution. This portion of the provision applies for income, gift, and estate tax purposes.

The provision provides for recapture of the income tax charitable deduction and gift tax charitable deduction under certain circumstances. First, if a donor makes an initial fractional contribution, then fails to contribute all of the donor's remaining interest in such property to the same donee before the earlier of 10 years from the initial fractional contribution or the donor's death, then the donee's charitable income and gift tax deductions for all previous contributions of interests in the item shall be recaptured (plus interest). If the donee of the initial contribution is no longer in existence as of such time, the donor's remaining interest may be contributed to another organization described in section 170(c) (which describes organizations to which contributions that are deductible for income tax purposes may be made). Second, if the donee of a fractional interest in an item of tangible personal property fails to take substantial physical possession of the item during

[827] Treas. Reg. sec. 1.170A–5(a)(4).
[828] Treas. Reg. sec. 1.170A–5(a)(2).
[829] See, e.g., *Winokur* v. *Commissioner*, 90 T.C. 733 (1988).

the period described above (the possession requirement) or fails to use the property for an exempt use during the period described above (the related-use requirement), then the donee's charitable income and gift tax deductions for all previous contributions of interests in the item shall be recaptured (plus interest). If, for example, an art museum described in section 501(c)(3) that is the donee of a fractional interest in a painting includes the painting in an art exhibit sponsored by the museum, such use generally will be treated as satisfying the related-use requirement of the provision.

In any case in which there is a recapture of a deduction as described in the preceding paragraph, the provision also imposes an additional tax in an amount equal to 10 percent of the amount recaptured.

Under the provision, no income or gift tax charitable deduction is allowed for a contribution of a fractional interest in an item of tangible personal property unless immediately before such contribution all interests in the item are owned (1) by the donor or (2) by the donor and the donee organization. The Secretary is authorized to make exceptions to this rule in cases where all persons who hold an interest in the item make proportional contributions of undivided interests in their respective shares of such item to the donee organization. For example, if A owns an undivided 40 percent interest in a painting and B owns an undivided 60 percent interest in the same painting, the Secretary may provide that A may take a deduction for a charitable contribution of less than the entire interest held by A, provided that both A and B make proportional contributions of undivided fractional interests in their respective shares of the painting to the same donee organization (e.g., if A contributes 50 percent of A's interest and B contributes 50 percent of B's interest).

It is intended that a contribution occurring before the date of enactment not be treated as an initial fractional contribution for purposes of the provision. Instead, the first fractional contribution by a taxpayer after the date of enactment would be considered the initial fractional contribution under the provision, regardless of whether the taxpayer had made a contribution of a fractional interest in the same item of tangible personal property prior to the date of enactment.

### *Effective Date*

The provision is applicable for contributions, bequests, and gifts made after the date of enactment (August 17, 2006).

## 9. Provisions relating to substantial and gross overstatements of valuations (sec. 1219 of the Act and secs. 170, 6662, 6664, 6696 and new sec. 6695A of the Code)

### *Present Law*

#### *Taxpayer penalties*

Present law imposes accuracy-related penalties on a taxpayer in cases involving a substantial valuation misstatement or gross valu-

ation misstatement relating to an underpayment of income tax.[830] For this purpose, a substantial valuation misstatement generally means a value claimed that is at least twice (200 percent or more) the amount determined to be the correct value, and a gross valuation misstatement generally means a value claimed that is at least four times (400 percent or more) the amount determined to be the correct value.

The penalty is 20 percent of the underpayment of tax resulting from a substantial valuation misstatement and rises to 40 percent for a gross valuation misstatement. No penalty is imposed unless the portion of the underpayment attributable to the valuation misstatement exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). Under present law, no penalty is imposed with respect to any portion of the understatement attributable to any 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 and there is a reasonable basis for the tax treatment. Special rules apply to tax shelters.

Present law also imposes an accuracy-related penalty on substantial or gross estate or gift tax valuation understatements.[831] In general, there is a substantial estate or gift tax understatement if the value of any property claimed on any return is 50 percent or less of the amount determined to be the correct amount, and a gross understatement of estate or gift tax if such value is 25 percent or less of the amount determined to be the correct amount.

In addition, the accuracy-related penalties do not apply if a taxpayer shows there was reasonable cause for an underpayment and the taxpayer acted in good faith.[832]

### *Penalty for aiding and abetting understatement of tax*

A penalty is imposed on a person who: (1) aids or assists in or advises with respect to a tax return or other document; (2) knows (or has reason to believe) that such document will be used in connection with a material tax matter; and (3) knows that this would result in an understatement of tax of another person. In general, the amount of the penalty is $1,000. If the document relates to the tax return of a corporation, the amount of the penalty is $10,000.

### *Qualified appraisals*

Present law requires a taxpayer to obtain a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.[833] Treasury Regulations state that a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170; (2) is prepared, signed, and dated by a qualified ap-

[830] Sec. 6662(b)(3) and (h).
[831] Sec. 6662(g) and (h).
[832] Sec. 6664(c).
[833] Sec. 170(f)(11).

praiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[834]

### *Qualified appraisers*

Treasury Regulations define a qualified appraiser as a person who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis, is qualified to make appraisals of the type of property being valued (as determined by the appraiser's background, experience, education and membership, if any, in professional appraisal associations), is independent, and understands that an intentionally false or fraudulent overstatement of the value of the appraised property may subject the appraiser to civil penalties.[835]

### *Appraiser oversight*

The Secretary is authorized to regulate the practice of representatives of persons before the Department of the Treasury ("Department").[836] After notice and hearing, the Secretary is authorized to suspend or disbar from practice before the Department or the Internal Revenue Service ("IRS") a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department or the IRS, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented).

The Secretary also is authorized to bar from appearing before the Department or the IRS, for the purpose of offering opinion evidence on the value of property or other assets, any individual against whom a civil penalty for aiding and abetting the understatement of tax has been assessed. Thus, an appraiser who aids or assists in the preparation or presentation of an appraisal will be subject to disciplinary action if the appraiser knows that the appraisal will be used in connection with the tax laws and will result in an understatement of the tax liability of another person. The Secretary has authority to provide that the appraisals of an appraiser who has been disciplined have no probative effect in any administrative proceeding before the Department or the IRS.

## *Explanation of Provision*

### *Taxpayer penalties*

The provision lowers the thresholds for imposing accuracy-related penalties on a taxpayer. Under the provision, a substantial valuation misstatement exists when the claimed value of any property is 150 percent or more of the amount determined to be the correct value. A gross valuation misstatement occurs when the

[834] Treas. Reg. sec. 1.170A–13(c)(3).
[835] Treas. Reg. sec. 1.170A–13(c)(5)(i).
[836] 31 U.S.C. sec. 330.

claimed value of any property is 200 percent or more of the amount determined to be the correct value.

The provision tightens the thresholds for imposing accuracy-related penalties with respect to the estate or gift tax. Under the provision, a substantial estate or gift tax valuation misstatement exists when the claimed value of any property is 65 percent or less of the amount determined to be the correct value. A gross misstatement of estate or gift tax valuation exists when the claimed value of any property is 40 percent or less of the amount determined to be the correct value.

Under the provision, the reasonable cause exception to the accuracy-related penalty does not apply in the case of gross valuation misstatements.

***Appraiser oversight***

*Appraiser penalties*

The provision establishes a civil penalty on any person who prepares an appraisal that is to be used to support a tax position if such appraisal results in a substantial or gross valuation misstatement. The penalty is equal to the greater of $1,000 or 10 percent of the understatement of tax resulting from a substantial or gross valuation misstatement, up to a maximum of 125 percent of the gross income derived from the appraisal. Under the provision, the penalty does not apply if the appraiser establishes that it was "more likely than not" that the appraisal was correct.

*Disciplinary proceeding*

The provision eliminates the requirement that the Secretary assess against an appraiser the civil penalty for aiding and abetting the understatement of tax before such appraiser may be subject to disciplinary action. Thus, the Secretary is authorized to discipline appraisers after notice and hearing. Disciplinary action may include, but is not limited to, suspending or barring an appraiser from: preparing or presenting appraisals on the value of property or other assets to the Department or the IRS; appearing before the Department or the IRS for the purpose of offering opinion evidence on the value of property or other assets; and providing that the appraisals of an appraiser who has been disciplined have no probative effect in any administrative proceeding before the Department or the IRS.

*Qualified appraisers*

The provision defines a qualified appraiser as an individual who (1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements to be determined by the IRS in regulations; (2) regularly performs appraisals for which he or she receives compensation; (3) can demonstrate verifiable education and experience in valuing the type of property for which the appraisal is being performed; (4) has not been prohibited from practicing before the IRS by the Secretary at any time during the three years preceding the conduct of the appraisal; and (5) is not ex-

cluded from being a qualified appraiser under applicable Treasury regulations.

*Qualified appraisals*

The provision defines a qualified appraisal as an appraisal of property prepared by a qualified appraiser (as defined by the provision) in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary.

### *Effective Date*

The provision amending the accuracy-related penalty applies to returns filed after the date of enactment (August 17, 2006). The provision establishing a civil penalty that may be imposed on any person who prepares an appraisal that is to be used to support a tax position if such appraisal results in a substantial or gross valuation misstatement applies to appraisals prepared with respect to returns or submissions filed after the date of enactment. The provisions relating to appraiser oversight apply to appraisals prepared with respect to returns or submissions filed after the date of enactment. With respect to any contribution of a qualified real property interest which is a restriction with respect to the exterior of a building described in section 170(h)(4)(C)(ii) (previously designated section 170(h)(4)(B)(ii), relating to certain property located in a registered historic district and certified as being of historic significance to the district), and any appraisal with respect to such contribution, the provision generally applies to returns filed after July 25, 2006.

## 10. Additional exemption standards for credit counseling organizations (sec. 1220 of the Act and secs. 501 and 513 of the Code)

### *Present Law*

Under present law, a credit counseling organization may be exempt as a charitable or educational organization described in section 501(c)(3), or as a social welfare organization described in section 501(c)(4). The IRS has issued two revenue rulings holding that certain credit counseling organizations are exempt as charitable or educational organizations or as social welfare organizations.

In Revenue Ruling 65–299,[837] an organization whose purpose was to assist families and individuals with financial problems, and help reduce the incidence of personal bankruptcy, was determined to be a social welfare organization described in section 501(c)(4). The organization counseled people in financial difficulties, advised applicants on payment of debts, and negotiated with creditors and set up debt repayment plans. The organization did not restrict its services to the poor, made no charge for counseling services, and made a nominal charge for certain services to cover postage and supplies. For financial support, the organization relied on voluntary contributions from local businesses, lending agencies, and labor unions.

[837] Rev. Rul. 65–299, 1965–2 C.B. 165.

In Revenue Ruling 69–441,[838] the IRS ruled an organization was a charitable or educational organization exempt under section 501(c)(3) by virtue of aiding low-income people who had financial problems and providing education to the public. The organization in that ruling had two functions: (1) educating the public on personal money management, such as budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications; and (2) providing individual counseling to low-income individuals and families without charge. As part of its counseling activities, the organization established debt management plans for clients who required such services, at no charge to the clients.[839] The organization was supported by contributions primarily from creditors, and its board of directors was comprised of representatives from religious organizations, civic groups, labor unions, business groups, and educational institutions.

In 1976, the IRS denied exempt status to an organization, Consumer Credit Counseling Service of Alabama, whose activities were distinguishable from those in Revenue Ruling 69–441 in that (1) it did not restrict its services to the poor, and (2) it charged a nominal fee for its debt management plans.[840] The organization provided free information to the general public through the use of speakers, films, and publications on the subjects of budgeting, buying practices, and the use of consumer credit. It also provided counseling to debt-distressed individuals, not necessarily poor or low-income, and provided debt management plans at the cost of $10 per month, which was waived in cases of financial hardship. Its debt management activities were a relatively small part of its overall activities. The district court determined the organization qualified as charitable and educational within section 501(c)(3), finding the debt management plans to be an integral part of the agency's counseling function, and that its debt management activities were incidental to its principal functions, as only approximately 12 percent of the counselors' time was applied to such programs and the charge for the service was nominal. The court also considered the facts that the agency was publicly supported, and that it had a board dominated by members of the general public, as factors indicating a charitable operation.[841]

A recent estimate shows the number of credit counseling organizations increased from approximately 200 in 1990 to over 1,000 in 2002.[842] During the period from 1994 to late 2003, 1,215 credit counseling organizations applied to the IRS for tax exempt status under section 501(c)(3), including 810 during 2000 to 2003.[843] The

---

[838] Rev. Rul. 69–441, 1969–2 C.B. 115.

[839] Debt management plans are debt payment arrangements, including debt consolidation arrangements, entered into by a debtor and one or more of the debtor's creditors, generally structured to reduce the amount of a debtor's regular ongoing payment by modifying the interest rate, minimum payment, maturity or other terms of the debt. Such plans frequently are promoted as a means for a debtor to restructure debt without filing for bankruptcy.

[840] *Consumer Credit Counseling Service of Alabama, Inc.* v. *U.S.,* 44 A.F.T.R. 2d (RIA) 5122 (D.D.C. 1978). The case involved 24 agencies throughout the United States.

[841] *See also, Credit Counseling Centers of Oklahoma, Inc.,* v. *U.S.,* 45 A.F.T.R. 2d (RIA) 1401 (D.D.C. 1979) (holding the same on virtually identical facts).

[842] Opening Statement of The Honorable Max Sandlin, Hearing on Non-Profit Credit Counseling Organizations, House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[843] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling,* Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investiga-

IRS has recognized more than 850 credit counseling organizations as tax exempt under section 501(c)(3).[844] Few credit counseling organizations have sought section 501(c)(4) status, and the IRS reports it has not seen any significant increase in the number or activity of such organizations operating as social welfare organizations.[845] As of late 2003, there were 872 active tax-exempt credit counseling agencies operating in the United States.[846]

A credit counseling organization described in section 501(c)(3) is exempt from certain Federal and State consumer protection laws that provide exemptions for organizations described therein.[847] Some believe that these exclusions from Federal and State regulation may be a primary motivation for the recent increase in the number of organizations seeking and obtaining exempt status under section 501(c)(3).[848] Such regulatory exemptions generally are not available for social welfare organizations described in section 501(c)(4).

Congress recently conducted hearings investigating the activities of credit counseling organizations under various consumer protection laws,[849] such as the Federal Trade Commission Act.[850] In addition, the IRS commenced a broad examination and compliance program with respect to the credit counseling industry. On May 15, 2006, the IRS announced that over the past two years, it had been auditing 63 credit counseling agencies, representing more than 40 percent of the revenue in the industry. Audits of 41 organizations, representing more than 40 percent of the revenue in the industry have been completed as of that date. All of such completed audits resulted in revocation, proposed revocation, or other termination of

---

tions and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 3 (citing letter dated December 18, 2003, to the Subcommittee from IRS Commissioner Everson).

[844] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[845] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[846] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling,* Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 3 (citing letter dated December 18, 2003 to the Subcommittee from IRS Commissioner Everson).

[847] E.g., The Credit Repair Organizations Act, 15 U.S.C. section 1679 *et seq.,* effective April 1, 1997 (imposing restrictions on credit repair organizations that are enforced by the Federal Trade Commission, including forbidding the making of untrue or misleading statements and forbidding advance payments; section 501(c)(3) organizations are explicitly exempt from such regulation). Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003) (California's consumer protections laws that impose strict standards on credit service organizations and the credit repair industry do not apply to nonprofit organizations that have received a final determination from the IRS that they are exempt from tax under section 501(c)(3) and are not private foundations).

[848] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[849] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling,* Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004.

[850] 15 U.S.C. sec. 45(a) (prohibiting unfair and deceptive acts or practices in or affecting commerce; although the Federal Trade Commission generally lacks jurisdiction to enforce consumer protection laws against bona fide nonprofit organizations, it may assert jurisdiction over a nonprofit, including a credit counseling organization, if it demonstrates the organization is organized to carry on business for profit, is a mere instrumentality of a for-profit entity, or operates through a common enterprise with one or more for-profit entities).

tax-exempt status.[851] In addition, the IRS released two legal documents that provide a legal framework for determining the exempt status and related issues with respect to credit counseling organizations.[852] In CCA 200620001, the IRS found that "[t]he critical inquiry is whether a credit counseling organization conducts its counseling program to improve an individual debtor's understanding of his financial problems and improve his ability to address those problems." The CCA concluded that whether a credit counseling organization primarily furthers educational purposes

> can be determined by assessing the methodology by which the organization conducts its counseling activities. The process an organization uses to interview clients and develop recommendations, train its counselors and market its services can distinguish between an organization whose object is to improve a person's knowledge and skills to manage his personal debt, and an organization that is offering counseling primarily as a mechanism to enroll individuals in a specific option (e.g., debt management plans) without considering the individual's best interest.

Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Public Law 109–8, an individual generally may not be a debtor in bankruptcy unless such individual has, within 180 days of filing a petition for bankruptcy, received from an approved nonprofit budget and credit counseling agency an individual or group briefing that outlines the opportunities for available credit counseling and assists the individual in performing a related budget analysis.[853] The clerk of the court must maintain a publicly available list of nonprofit budget and credit counseling agencies approved by the U.S. Trustee (or bankruptcy administrator). In general, the U.S. Trustee (or bankruptcy administrator) shall only approve an agency that demonstrates that it will provide qualified counselors, maintain adequate provision for safekeeping and payment of client funds, provide adequate counseling with respect to client credit problems, and deal responsibly and effectively with other matters relating to the quality, effectiveness, and financial security of the services it provides. The minimum qualifications for approval of such an agency include: (1) in general, having an independent board of directors; (2) charging no more than a reasonable fee, and providing services without regard to ability to pay; (3) adequate provision for safekeeping and payment of client funds; (4) provision of full disclosures to clients; (5) provision of adequate counseling with respect to a client's credit problems; (6) trained counselors who receive no commissions or bonuses based on the outcome of the counseling services; (7) experience and background

[851] IRS News Release, IR–2006–80, May 15, 2006.

[852] Chief Counsel Advice 200431023 (July 13, 2004); Chief Counsel Advice 200620001 (May 9, 2006).

[853] This requirement does not apply in certain circumstances, such as: (1) in general, where a debtor resides in a district for which the U.S. Trustee has determined that the approved counseling agencies for such district are not reasonably able to provide adequate services to additional individuals; (2) where exigent circumstances merit a waiver, the individual seeking bankruptcy protection files an appropriate certification with the court, and the certification is acceptable to the court; and (3) in general, where a court determines, after notice and hearing, that the individual is unable to complete the requirement because of incapacity, disability, or active military duty in a military combat zone.

in providing credit counseling; and (8) adequate financial resources to provide continuing support services for budgeting plans over the life of any repayment plan. An individual debtor must file with the court a certificate from the approved nonprofit budget and credit counseling agency that provided the required services describing the services provided, and a copy of the debt management plan, if any, developed through the agency.[854]

### *Explanation of Provision*

#### *Requirements for exempt status of credit counseling organizations*

The provision establishes standards that a credit counseling organization must satisfy, in addition to present law requirements, in order to be organized and operated either as an organization described in section 501(c)(3) or in section 501(c)(4). The provision does not diminish the requirements set forth recently by the IRS in Chief Counsel Advice 200431023 or Chief Counsel Advice 200620001 but builds on and is consistent with such requirements, and the analysis therein. The provision is not intended to raise any question about IRS actions taken, and the IRS is expected to continue its vigorous examination of the credit counseling industry, applying the additional standards provided by the provision. The provision does not and is not intended to affect the approval process for credit counseling agencies under Public Law 109–8. Public Law 109–8 requires that an approved credit counseling agency be a nonprofit, and does not require that an approved agency be a section 501(c)(3) organization. It is expected that the Department of Justice shall continue to approve agencies for purposes of providing pre-bankruptcy counseling based on criteria that are consistent with such Public Law.

Under the provision, an organization that provides credit counseling services as a substantial purpose of the organization ("credit counseling organization") is eligible for exemption from Federal income tax only as a charitable or educational organization under section 501(c)(3) or as a social welfare organization under section 501(c)(4), and only if (in addition to present-law requirements) the credit counseling organization is organized and operated in accordance with the following:

1. The organization provides credit counseling services tailored to the specific needs and circumstances of the consumer;

2. The organization makes no loans to debtors (other than loans with no fees or interest) and does not negotiate the making of loans on behalf of debtors;[855]

3. The organization provides services for the purpose of improving a consumer's credit record, credit history, or credit rating only to the extent that such services are incidental to pro-

[854] The Act also requires that, prior to discharge of indebtedness under chapter 7 or chapter 13, a debtor complete an approved instructional course concerning personal financial management, which course need not be conducted by a nonprofit agency.

[855] In general, negotiation of a loan involves negotiation of the terms of a loan, rather than the processing of a loan. Organizations that provide assistance to consumers to obtain a loan from the Department of Housing and Urban Development, for example, are not necessarily negotiating a loan for a consumer.

viding credit counseling services and does not charge any separately stated fee for any such services;[856]

4. The organization does not refuse to provide credit counseling services to a consumer due to inability of the consumer to pay, the ineligibility of the consumer for debt management plan enrollment, or the unwillingness of a consumer to enroll in a debt management plan;

5. The organization establishes and implements a fee policy to require that any fees charged to a consumer for its services are reasonable,[857] allows for the waiver of fees if the consumer is unable to pay, and except to the extent allowed by State law prohibits charging any fee based in whole or in part on a percentage of the consumer's debt, the consumer's payments to be made pursuant to a debt management plan, or on the projected or actual savings to the consumer resulting from enrolling in a debt management plan;

6. The organization at all times has a board of directors or other governing body (a) that is controlled by persons who represent the broad interests of the public, such as public officials acting in their capacities as such, persons having special knowledge or expertise in credit or financial education, and community leaders; (b) not more than 20 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees or the repayment of consumer debt to creditors other than the credit counseling organization or its affiliates) and (c) not more than 49 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees);[858]

7. The organization does not own (except with respect to a section 501(c)(3) organization) more than 35 percent of the total combined voting power of a corporation (or profits or beneficial interest in the case of a partnership or trust or estate) that is in the trade or business of lending money, repairing credit, or providing debt management plan services, payment processing, and similar services; and

---

[856] Accordingly, a credit counseling organization may provide credit repair type services, but only to the extent that the provision of such services is a direct outgrowth of the provision of credit counseling services.

[857] Whether a credit counseling organization's fees are consistent with specific State law requirements is evidence of the reasonableness of fees but is not determinative.

[858] The requirements described in paragraphs 4, 5, and 6 above address core issues that are related to tax-exempt status and that have proved to be problematic in the credit counseling industry—the provision of services and waiver of fees without regard to ability to pay, the establishment of a reasonable fee policy, and the presence of independent board members. No inference is intended through the provision of these specific requirements on credit counseling organizations that similar or more stringent requirements should not be adhered to by other exempt organizations providing fees for services. Rather, the provision affirms the importance of these core issues to the matter of tax exemption, both to credit counseling organizations and to other types of exempt organizations.

8. The organization receives no amount for providing referrals to others for debt management plan services, and pays no amount to others for obtaining referrals of consumers.[859]

***Additional requirements for charitable and educational organizations***

Under the provision, a credit counseling organization is described in section 501(c)(3) only if, in addition to satisfying the above requirements and the requirements of section 501(c)(3), the organization is organized and operated such that the organization (1) does not solicit contributions from consumers during the initial counseling process or while the consumer is receiving services from the organization and (2) the aggregate revenues of the organization that are from payments of creditors of consumers of the organization and that are attributable to debt management plan services do not exceed the applicable percentage of the total revenues of the organization. For credit counseling organizations in existence on the date of enactment, the applicable percentage is 80 percent for the first taxable year of the organization beginning after the date which is one year after the date of enactment, 70 percent for the second such taxable year beginning after such date, 60 percent for the third such taxable year beginning after such date, and 50 percent thereafter. For new credit counseling organizations, the applicable percentage is 50 percent for taxable years beginning after the date of enactment. Satisfaction of the aggregate revenues requirement is not a safe harbor; all other requirements of the provision (and of section 501(c)(3)) pertaining to section 501(c)(3) organizations also must be satisfied. Satisfaction of the aggregate revenues requirement means only that an organization has not automatically failed to be organized or operated consistent with exempt purposes. Compliance with the revenues test does not mean that the organization's debt management plan services activity is at a level that organizationally or operationally is consistent with exempt status. In other words, satisfaction of the aggregate revenues requirement (as a preliminary matter in an exemption application, or on an ongoing operational basis) provides no affirmative evidence that an organization's primary purpose is an exempt purpose, or that the revenues that are subject to the limitation (or debt management plan services revenues more generally) are related to exempt purposes. As described below, whether revenues from such activity are substantially related to exempt purposes depends on the facts and circumstances, that is, satisfaction of the aggregate revenues requirement generally is not relevant for purposes of whether any of an organization's revenues are revenues from an unrelated trade or business. Failure to satisfy the aggregate revenues requirement does not disqualify the organization from recognition of exemption under section 501(c)(4).

***Additional requirement for social welfare organizations***

Under the provision, a credit counseling organization is described in section 501(c)(4) only if, in addition to satisfying the above re-

[859] If a credit counseling organization pays or receives a fee, for example, for using or maintaining a locator service for consumers to find a credit counseling organization, such a fee is not considered a referral.

quirements applicable to such organizations, the organization notifies the Secretary, in such manner as the Secretary may by regulations prescribe, that it is applying for recognition as a credit counseling organization.

***Debt management plan services treated as an unrelated trade or business***

Under the provision, debt management plan services are treated as an unrelated trade or business for purposes of the tax on income from an unrelated trade or business to the extent such services are provided by an organization that is not a credit counseling organization. With respect to the provision of debt management plan services by a credit counseling organization, in order for the income from such services not to be unrelated business income, it is intended that, consistent with current law, the debt management plan service with respect to such income (1) must contribute importantly to the accomplishment of credit counseling services, and (2) must not be conducted on a larger scale than reasonably is necessary for the accomplishment of such services. For example, the provision of debt management plan services would not be substantially related to accomplishing exempt purposes if the organization recommended and enrolled an individual in a debt management plan only after determining whether the individual satisfied the financial criteria established by the creditors for such plan, without (1) considering whether it was an appropriate action in light of the individual's particular needs and objectives, (2) discussing the disadvantages of a debt management plan with the consumer, and (3) presenting other possible options to such consumer.

***Definitions***

*Credit counseling services*

Credit counseling services are (a) the provision of educational information to the general public on budgeting, personal finance, financial literacy, saving and spending practices, and the sound use of consumer credit; (b) the assisting of individuals and families with financial problems by providing them with counseling; or (c) any combination of such activities.

*Debt management plan services*

Debt management plan services are services related to the repayment, consolidation, or restructuring of a consumer's debt, and includes the negotiation with creditors of lower interest rates, the waiver or reduction of fees, and the marketing and processing of debt management plans.

## *Effective Date*

In general, the provision applies to taxable years beginning after the date of enactment (August 17, 2006). For a credit counseling organization that is described in section 501(c)(3) or 501(c)(4) on the date of enactment, the provision is effective for taxable years beginning after the date that is one year after the date of enactment.

## 11. Expansion of the base of tax on private foundation net investment income (sec. 1221 of the Act and sec. 4940 of the Code)

### *Present Law*

#### *In general*

Under section 4940(a) of the Code, private foundations that are recognized as exempt from Federal income tax under section 501(a) of the Code are subject to a two-percent excise tax on their net investment income. Private foundations that are not exempt from tax, such as certain charitable trusts,[860] also are subject to an excise tax under section 4940(b) based on net investment income and unrelated business income. The two-percent rate of tax is reduced to one-percent if certain requirements are met in a taxable year.[861] Unlike certain other excise taxes imposed on private foundations, the tax based on investment income does not result from a violation of substantive law by the private foundation; it is solely an excise tax.

The tax on taxable private foundations under section 4940(b) is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation were tax exempt and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code.

#### *Net investment income*

##### *Internal Revenue Code*

In general, net investment income is defined as the amount by which the sum of gross investment income and capital gain net income exceeds the deductions relating to the production of gross investment income.[862]

Gross investment income is the gross amount of income from interest, dividends, rents, payments with respect to securities loans, and royalties. Gross investment income does not include any income that is included in computing a foundation's unrelated business taxable income.[863]

Capital gain net income takes into account only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties, and property used for the production of income included in computing the unrelated business income tax (except to the extent the gain or loss is taken into account for purposes of such tax). Losses from sales or other dispositions of property are allowed only to the extent of gains from

---

[860] *See* sec. 4947(a)(1).

[861] Sec. 4940(e).

[862] Sec. 4940(c)(1). Net investment income also is determined by applying section 103 (generally providing an exclusion for interest on certain State and local bonds) and section 265 (generally disallowing the deduction for interest and certain other expenses with respect to tax-exempt income). Sec. 4940(c)(5).

[863] Sec. 4940(c)(2).

such sales or other dispositions, and no capital loss carryovers are allowed.[864]

*Treasury Regulations and case law*

The Treasury regulations elaborate on the Code definition of net investment income. The regulations cite items of investment income listed in the Code, and in addition clarify that net investment income includes interest, dividends, rents, and royalties derived from all sources, including from assets devoted to charitable activities. For example, interest received on a student loan is includible in the gross investment income of a foundation making the loan.[865]

The regulations further provide that gross investment income includes certain items of investment income that are described in the unrelated business income tax regulations.[866] Such additional items include payments with respect to securities loans (an item added to the Code in 1978), annuities, income from notional principal contracts, and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner.[867] These latter three categories of income are not enumerated as net investment income in the Code.

The Treasury regulations also elaborate on the Code definition of capital gain net income. The regulations provide that the only capital gains and losses that are taken into account are (1) gains and losses from the sale or other disposition of property held by a private foundation for investment purposes (other than program related investments), and (2) property used for the production of income included in computing the unrelated business income tax (except to the extent the gain or loss is taken into account for purposes of such tax).

This definition of capital gain net income builds on the definition provided in the Code by providing an exception for gain and loss from program related investments and by stating, in addition, that "gains and losses from the sale or other disposition of property used for the exempt purposes of the private foundation are excluded."[868] As an example, the regulations provide that gain or loss on the sale of buildings used for the foundation's exempt activities are not taken into account for purposes of the section 4940 tax. If a foundation uses exempt income for exempt purposes and (other than incidentally) for investment purposes, then the portion of the gain or loss received upon sale or other disposition that is allocable to the investment use is taken into account for purposes of the tax.

The regulations further provide that "property shall be treated as held for investment purposes even though such property is disposed of by the foundation immediately upon its receipt, if it is property of a type which generally produces interest, dividends, rents, royalties, or capital gains through appreciation (for example, rental real estate, stock, bonds, mineral interest, mortgages, and securities)."[869]

---

[864] Sec. 4940(c)(4).
[865] Treas. Reg. sec. 53.4940–1(d)(1).
[866] *Id.*
[867] Treas. Reg. sec. 1.512(b)–1(a)(1).
[868] Treas. Reg. sec. 53.4940–1(f)(1).
[869] *Id.*

This regulation has been challenged in the courts. The regulation says that property is treated as held for investment purposes if it is of a type that "generally produces" certain types of income. By contrast, the Code provides that the property be "used" to produce such income. In Zemurray Foundation v. United States, 687 F.2d 97 (5th Cir. 1982), the taxpayer foundation challenged the Treasury's attempt to tax under section 4940 capital gain on the sale of timber property. The taxpayer asserted that the property was not actually used to produce investment income, and that the Treasury Regulation was invalid because the regulation would subject to tax property that is of a type that could generally be used to produce investment income. On this issue, the court upheld the Treasury regulation, reasoning that the regulation's use of the phrase "generally used," though permitting taxation "so long as the property sold is usable to produce the applicable types of income, regardless of whether the property is actually used to produce income or not" was not unreasonable or plainly inconsistent with the statute.[870] However, on remand to the district court, the district court concluded that the timber property at issue, though a type of property generally used to produce investment income, was not susceptible for such use.[871] Thus, the district court concluded that the Treasury could not tax the gain under this portion of the regulation.

The question then turned to the taxpayer's second challenge to the regulation. At issue was the meaning of the regulatory phrase "capital gains through appreciation." The regulation provides that if property is of a type that generally produces capital gains through appreciation, then the gain is subject to tax. The Treasury argued that the timber property at issue, although held by the court not to be property (in this case) susceptible for use to produce interest, dividends, rents, or royalties, still was held by the taxpayer to produce capital gain through appreciation and therefore the gain should be subject to tax under the regulation.

On this issue, the court held for the taxpayer, reasoning that the language of the Code clearly is limited to certain gains and losses, e.g., the court cited the Code language providing that "there shall be taken into account only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties. . . ."[872] The court noted that "capital gains through appreciation" is not enumerated in the statute. The court used as an example a jade figurine held by a foundation. Jade figurines do not generally produce interest, dividends, rents, or royalties, but gain on the sale of such a figurine would be taxable under the "capital gains through appreciation" standard, yet such standard does not appear in the statute. After Zemurray, the Treasury generally conceded this issue.[873]

With respect to capital losses, the Code provides that carryovers are not permitted, whereas the regulations state that neither carryovers nor carrybacks are permitted.[874]

---

[870] *Zemurray Foundation v. United States,* 687 F.2d 97, 100 (5th Cir. 1982).
[871] *Zemurray Foundation v. United States,* 53 A.F.T.R. 2d (RIA) 842 (E. D. La. 1983).
[872] *Zemurray Foundation v. United States,* 755 F.2d 404 (5th Cir. 1985), 413 (citing Code sec. 4940(c)(4)(A).
[873] G.C.M. 39538 (July 23, 1986).
[874] Treas. Reg. sec. 53.4940–1(f)(3).

*Application of Zemurray to the Code and the regulations*

Applying the Zemurray case to the Code and regulations results in a general principle for purposes of present law: private foundations are subject to tax under section 4940 only on the items of income and only on gains and losses specifically enumerated therein. Under this principle, private foundations generally are not subject to the section 4940 tax on other substantially similar types of income from ordinary and routine investments, notwithstanding Treasury regulations to the contrary. In addition, the regulations provide that gain or loss from the sale or other disposition of assets used for exempt purposes, with specific reference to program-related investments, is excluded. The Code provides for no such blanket exclusion; thus, under the language of the Code and the reasoning of Zemurray, if a foundation provided office space at below market rent to a charitable organization for use in the organization's exempt purposes, gain on the sale of the building by the foundation should be subject to the section 4940 tax despite the Treasury regulations.[875]

In addition, under the logic of Zemurray, capital loss carrybacks arguably are permitted, notwithstanding Treasury regulations to the contrary, because the Code mentions only a bar on use of carryovers and says nothing about carrybacks.

### *Explanation of Provision*

The provision amends the definition of gross investment income (including for purposes of capital gain net income) to include items of income that are similar to the items presently enumerated in the Code. Such similar items include income from notional principal contracts, annuities, and other substantially similar income from ordinary and routine investments, and, with respect to capital gain net income, capital gains from appreciation, including capital gains and losses from the sale or other disposition of assets used to further an exempt purpose.

Certain gains and losses are not taken into account in determining capital gain net income. Specifically, under the provision, no gain or loss shall be taken into account with respect to any portion of property used for a period of not less than one year for a purpose or function constituting the basis of the private foundation's exemption, if the entire property is exchanged immediately following such period solely for property of like kind which is to be used primarily for a purpose or function constituting the basis for such foundation's exemption. Rules similar to the rules of section 1031 (relating to exchange of property held for productive use or investment) apply, including, but not limited to, the exceptions of section 1031(a)(2) and the rule of section 1031(a)(3) regarding completion of the exchange within 180 days.

The provision provides that there are no carrybacks of losses from sales or other dispositions of property.

[875] *See* also the example in Treas. Reg. sec. 53.4940–1(f)(1).

### *Effective Date*

The provision is effective for taxable years beginning after the date of enactment (August 17, 2006).

## 12. Definition of convention or association of churches (sec. 1222 of the Act and sec. 7701 of the Code)

### *Present Law*

Under present law, an organization that qualifies as a "convention or association of churches" (within the meaning of sec. 170(b)(1)(A)(i)) is not required to file an annual return,[876] is subject to the church tax inquiry and church tax examination provisions applicable to organizations claiming to be a church,[877] and is subject to certain other provisions generally applicable to churches.[878] The Internal Revenue Code does not define the term "convention or association of churches."

### *Explanation of Provision*

The provision provides that an organization that otherwise is a convention or association of churches does not fail to so qualify merely because the membership of the organization includes individuals as well as churches, or because individuals have voting rights in the organization.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## 13. Notification requirement for entities not currently required to file an annual information return (sec. 1223 of the Act and secs. 6033, 6652, and 7428 of the Code)

### *Present Law*

Under present law, the requirement that an exempt organization file an annual information return does not apply to several categories of exempt organizations. Organizations excepted from the filing requirement include organizations (other than private foundations), the gross receipts of which in each taxable year normally are not more than $25,000.[879] Also exempt from the requirement

---

[876] Sec. 6033(a)(2)(A)(i).

[877] Sec. 7611(h)(1)(B).

[878] *See, e.g.,* Sec. 402(g)(8)(B) (limitation on elective deferrals); sec. 403(b)(9)(B) (definition of retirement income account); sec. 410(d) (election to have participation, vesting, funding, and certain other provisions apply to church plans); sec. 414(e) (definition of church plan); sec. 415(c)(7) (certain contributions by church plans); sec. 501(h)(5) (disqualification of certain organizations from making the sec. 501(h) election regarding lobbying expenditure limits); sec. 501(m)(3) (definition of commercial-type insurance); sec. 508(c)(1)(A) (exception from requirement to file application seeking recognition of exempt status); sec. 512(b)(12) (allowance of up to $1,000 deduction for purposes of determining unrelated business taxable income); sec. 514(b)(3)(E) (definition of debt-financed property); sec. 3121(w)(3)(A) (election regarding exemption from social security taxes); sec. 3309(b)(1) (application of federal unemployment tax provisions to services performed in the employ of certain organizations); sec. 6043(b)(1) (requirement to file a return upon liquidation or dissolution of the organization); and sec. 7702(j)(3)(A) (treatment of certain death benefit plans as life insurance).

[879] Sec. 6033(a)(2); Treas. Reg. sec. 1.6033–2(a)(2)(i); Treas. Reg. sec. 1.6033–2(g)(1). Section 6033(a)(2)(A)(ii) provides a $5,000 annual gross receipts exception from the annual reporting re-

Continued

are churches, their integrated auxiliaries, and conventions or associations of churches; the exclusively religious activities of any religious order; section 501(c)(1) instrumentalities of the United States; section 501(c)(21) trusts; an interchurch organization of local units of a church; certain mission societies; certain church-affiliated elementary and high schools; certain State institutions whose income is excluded from gross income under section 115; certain governmental units and affiliates of governmental units; and other organizations that the IRS has relieved from the filing requirement pursuant to its statutory discretionary authority.

### *Explanation of Provision*

The provision requires organizations that are excused from filing an information return by reason of normally having gross receipts below a certain specified amount (generally, under $25,000) to furnish to the Secretary annually, in electronic form, the legal name of the organization, any name under which the organization operates or does business, the organization's mailing address and Internet web site address (if any), the organization's taxpayer identification number, the name and address of a principal officer, and evidence of the organization's continuing basis for its exemption from the generally applicable information return filing requirements. Upon such organization's termination of existence, the organization is required to furnish notice of such termination.

The provision provides that if an organization fails to provide the required notice for three consecutive years, the organization's tax-exempt status is revoked. In addition, if an organization that is required to file an annual information return under section 6033(a) (Form 990) fails to file such an information return for three consecutive years, the organization's tax- exempt status is revoked. If an organization fails to meet its filing obligation to the IRS for three consecutive years in cases where the organization is subject to the information return filing requirement in one or more years during a three-year period and also is subject to the notice requirement for one or more years during the same three-year period, the organization's tax-exempt status is revoked.

A revocation under the provision is effective from the date that the Secretary determines was the last day the organization could have timely filed the third required information return or notice. To again be recognized as tax-exempt, the organization must apply to the Secretary for recognition of tax-exemption, irrespective of whether the organization was required to make an application for recognition of tax-exemption in order to gain tax-exemption originally.

If, upon application for tax-exempt status after a revocation under the provision, the organization shows to the satisfaction of the Secretary reasonable cause for failing to file the required annual notices or returns, the organization's tax-exempt status may, in the discretion of the Secretary, be reinstated retroactive to the date of revocation. An organization may not challenge under the

---

quirements for certain exempt organizations. In Announcement 82–88, 1982–25 I.R.B. 23, the IRS exercised its discretionary authority under section 6033 to increase the gross receipts exception to $25,000, and enlarge the category of exempt organizations that are not required to file Form 990.

Code's declaratory judgment procedures (section 7428) a revocation of tax-exemption made pursuant to the provision.

There is no monetary penalty for failure to file the notice under the provision. Like other information returns, the notices are subject to the public disclosure and inspection rules generally applicable to exempt organizations. The provision does not affect an organization's obligation under present law to file required information returns or existing penalties for failure to file such returns.

The Secretary is required to notify every organization that is subject to the notice filing requirement of the new filing obligation in a timely manner. Notification by the Secretary shall be by mail, in the case of any organization the identity and address of which is included in the list of exempt organizations maintained by the Secretary, and by Internet or other means of outreach, in the case of any other organization. In addition, the Secretary is required to publicize in a timely manner in appropriate forms and instructions and other means of outreach the new penalty imposed for consecutive failures to file the information return.

The Secretary is authorized to publish a list of organizations whose exempt status is revoked under the provision.

### *Effective Date*

The provision is effective for notices and returns with respect to annual periods beginning after 2006.

### 14. Disclosure to State officials relating to exempt organizations (sec. 1224 of the Act and secs. 6103, 6104, 7213, 7213A, and 7431 of the Code)

### *Present Law*

In the case of organizations that are described in section 501(c)(3) and exempt from tax under section 501(a) or that have applied for exemption as an organization so described, present law (sec. 6104(c)) requires the Secretary to notify the appropriate State officer of (1) a refusal to recognize such organization as an organization described in section 501(c)(3), (2) a revocation of a section 501(c)(3) organization's tax-exempt status, and (3) the mailing of a notice of deficiency for any tax imposed under section 507, chapter 41, or chapter 42.[880] In addition, at the request of such appropriate State officer, the Secretary is required to make available for inspection and copying, such returns, filed statements, records, reports, and other information relating to the above-described disclosures, as are relevant to any State law determination. An appropriate State officer is the State attorney general, State tax officer, or any State official charged with overseeing organizations of the type described in section 501(c)(3).

In general, returns and return information (as such terms are defined in section 6103(b)) are confidential and may not be disclosed

[880] The applicable taxes include the termination tax on private foundations; taxes on public charities for certain excess lobbying expenses; taxes on a private foundation's net investment income, self-dealing activities, undistributed income, excess business holdings, investments that jeopardize charitable purposes, and taxable expenditures (some of these taxes also apply to certain non-exempt trusts); taxes on the political expenditures and excess benefit transactions of section 501(c)(3) organizations; and certain taxes on black lung benefit trusts and foreign organizations.

or inspected unless expressly provided by law.[881] Present law requires the Secretary to keep records of disclosures and requests for inspection[882] and requires that persons authorized to receive returns and return information maintain various safeguards to protect such information against unauthorized disclosure.[883] Willful unauthorized disclosure or inspection of returns or return information is subject to a fine and/or imprisonment.[884] The knowing or negligent unauthorized inspection or disclosure of returns or return information gives the taxpayer a right to bring a civil suit.[885] Such present-law protections against unauthorized disclosure or inspection of returns and return information do not apply to the disclosures or inspections, described above, that are authorized by section 6104(c).

### *Explanation of Provision*

The provision provides that upon written request by an appropriate State officer, the Secretary may disclose: (1) a notice of proposed refusal to recognize an organization as a section 501(c)(3) organization; (2) a notice of proposed revocation of tax-exemption of a section 501(c)(3) organization; (3) the issuance of a proposed deficiency of tax imposed under section 507, chapter 41, or chapter 42; (4) the names, addresses, and taxpayer identification numbers of organizations that have applied for recognition as section 501(c)(3) organizations; and (5) returns and return information of organizations with respect to which information has been disclosed under (1) through (4) above.[886] Disclosure or inspection is permitted for the purpose of, and only to the extent necessary in, the administration of State laws regulating section 501(c)(3) organizations, such as laws regulating tax-exempt status, charitable trusts, charitable solicitation, and fraud. Such disclosure or inspection may be made only to or by an appropriate State officer or to an officer or employee of the State who is designated by the appropriate State officer, and may not be made by or to a contractor or agent. The Secretary also is permitted to disclose or open to inspection the returns and return information of an organization that is recognized as tax- exempt under section 501(c)(3), or that has applied for such recognition, to an appropriate State officer if the Secretary determines that disclosure or inspection may constitute evidence of noncompliance under the laws within the jurisdiction of the appropriate State officer. For this purpose, appropriate State officer means the State attorney general, the State tax officer, or any other State official charged with overseeing organizations of the type described in section 501(c)(3).

In addition, the provision provides that upon the written request by an appropriate State officer, the Secretary may make available for inspection or disclosure returns and return information of an organization described in section 501(c) (other than section 501(c)(1) or section 501(c)(3)). Such returns and return information

[881] Sec. 6103(a).
[882] Sec. 6103(p)(3).
[883] Sec. 6103(p)(4).
[884] Secs. 7213 and 7213A.
[885] Sec. 7431.
[886] Such returns and return information also may be open to inspection by an appropriate State officer.

are available for inspection or disclosure only for the purpose of, and to the extent necessary in, the administration of State laws regulating the solicitation or administration of the charitable funds or charitable assets of such organizations. Such disclosure or inspection may be made only to or by an appropriate State officer or to an officer or employee of the State who is designated by the appropriate State officer, and may not be made by or to a contractor or agent. For this purpose, appropriate State officer means the State attorney general, the State tax officer, and the head of an agency designated by the State attorney general as having primary responsibility for overseeing the solicitation of funds for charitable purposes of such organizations.

In addition, the provision provides that any returns and return information disclosed under section 6104(c) may be disclosed in civil administrative and civil judicial proceedings pertaining to the enforcement of State laws regulating the applicable tax-exempt organization in a manner prescribed by the Secretary. Returns and return information are not to be disclosed under section 6104(c), or in such an administrative or judicial proceeding, to the extent that the Secretary determines that such disclosure would seriously impair Federal tax administration. The provision makes disclosures of returns and return information under section 6104(c) subject to the disclosure, recordkeeping, and safeguard provisions of section 6103, including through requirements that the Secretary maintain a permanent system of records of requests for disclosure (sec. 6103(p)(3)) and that the appropriate State officer maintain various safeguards that protect against unauthorized disclosure (sec. 6103(p)(4)). The provision provides that the willful unauthorized disclosure of returns or return information described in section 6104(c) is a felony subject to a fine of up to $5,000 and/or imprisonment of up to five years (sec. 7213(a)(2)), the willful unauthorized inspection of returns or return information described in section 6104(c) is subject to a fine of up to $1,000 and/or imprisonment of up to one year (sec. 7213A), and provides the taxpayer the right to bring a civil action for damages in the case of knowing or negligent unauthorized disclosure or inspection of such information (sec. 7431(a)(2)).

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006) but does not apply to requests made before such date.

## 15. Public disclosure relating to unrelated business income tax returns (sec. 1225 of the Act and sec. 6104 of the Code)

### *Present Law*

In general, an organization described in section 501(c) or (d) is required to make available for public inspection a copy of its annual information return (Form 990) and exemption application materials.[887] A penalty may be imposed on any person who does not make an organization's annual returns or exemption application materials available for public inspection. The penalty amount is

[887] Sec. 6104(d).

$20 for each day during which a failure occurs. If more than one person fails to comply, each person is jointly and severally liable for the full amount of the penalty. The maximum penalty that may be imposed on all persons for any one annual return is $10,000. There is no maximum penalty amount for failing to make exemption application materials available for public inspection. Any person who willfully fails to comply with the public inspection requirements is subject to an additional penalty of $5,000.[888]

These requirements do not apply to an organization's annual return for unrelated business income tax (generally Form 990–T).[889]

### *Explanation of Provision*

The provision extends the present-law public inspection and disclosure requirements and penalties applicable to the Form 990 to the unrelated business income tax return (Form 990–T) of organizations described in section 501(c)(3). The provision provides that certain information may be withheld by the organization from public disclosure and inspection if public availability would adversely affect the organization, similar to the information that may be withheld under present law with respect to applications for tax exemption and the Form 990 (e.g., information relating to a trade secret, patent, process, style of work, or apparatus of the organization, if the Secretary determines that public disclosure of such information would adversely affect the organization).

### *Effective Date*

The provision is effective for returns filed after the date of enactment (August 17, 2006).

## 116. Treasury study on donor advised funds and supporting organizations (sec. 1226 of the Act)

### *Present Law*

#### *Donor advised funds*

Some charitable organizations (including community foundations) establish accounts to which donors may contribute and thereafter provide nonbinding advice or recommendations with regard to distributions from the fund or the investment of assets in the fund. Such accounts are commonly referred to as "donor advised funds." Donors who make contributions to charities for maintenance in a donor advised fund generally claim a charitable contribution deduction at the time of the contribution. Although sponsoring charities frequently permit donors (or other persons appointed by donors) to provide nonbinding recommendations concerning the distribution or investment of assets in a donor advised fund, sponsoring charities generally must have legal ownership and control of such assets following the contribution. If the sponsoring charity does not have such control (or permits a donor to exercise control over amounts contributed), the donor's contributions may not qualify for a charitable deduction, and, in the case of a community foundation, the

[888] Sec. 6685.
[889] Treas. Reg. sec. 301.6104(d)–1(b)(4)(ii).

contribution may be treated as being subject to a material restriction or condition by the donor.

In recent years, a number of financial institutions have formed charitable corporations for the principal purpose of offering donor advised funds, sometimes referred to as "commercial" donor advised funds. In addition, some established charities have begun operating donor advised funds in addition to their primary activities. The IRS has recognized several organizations that sponsor donor advised funds, including "commercial" donor advised funds, as section 501(c)(3) public charities. The term "donor advised fund" is not defined in statute or regulations.

### *Supporting organizations*

#### *In general*

The Code provides that certain "supporting organizations" (in general, organizations that provide support to another section 501(c)(3) organization that is not a private foundation) are classified as public charities rather than private foundations.[890] To qualify as a supporting organization, an organization must meet all three of the following tests: (1) it must be organized and at all times operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more "publicly supported organizations"[891] (the "organizational and operational tests");[892] (2) it must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations (the "relationship test");[893] and (3) it must not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations (the "lack of outside control test").[894]

To satisfy the relationship test, a supporting organization must hold one of three statutorily described close relationships with the supported organization. The organization must be: (1) operated, supervised, or controlled by a publicly supported organization (commonly referred to as "Type I" supporting organizations); (2) supervised or controlled in connection with a publicly supported organization ("Type II" supporting organizations); or (3) operated in connection with a publicly supported organization ("Type III" supporting organizations).[895]

#### *Type I supporting organizations*

In the case of supporting organizations that are operated, supervised, or controlled by one or more publicly supported organizations (Type I supporting organizations), one or more supported organizations must exercise a substantial degree of direction over the policies, programs, and activities of the supporting organization.[896]

---

[890] Sec. 509(a)(3).

[891] In general, supported organizations of a supporting organization must be publicly supported charities described in sections 509(a)(1) or (a)(2).

[892] Sec. 509(a)(3)(A).

[893] Sec. 509(a)(3)(B).

[894] Sec. 509(a)(3)(C).

[895] Treas. Reg. sec. 1.509(a)–4(f)(2).

[896] Treas. Reg. sec. 1.509(a)-4(g)(1)(i).

The relationship between the Type I supporting organization and the supported organization generally is comparable to that of a parent and subsidiary. The requisite relationship may be established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.[897]

*Type II supporting organizations*

Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations. Rather than the parent-subsidiary relationship characteristic of Type I organizations, the relationship between a Type II organization and its supported organizations is more analogous to a brother-sister relationship. In order to satisfy the Type II relationship requirement, generally there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations.[898] An organization generally is not considered to be "supervised or controlled in connection with" a publicly supported organization merely because the supporting organization makes payments to the publicly supported organization, even if the obligation to make payments is enforceable under state law.[899]

*Type III supporting organizations*

Type III supporting organizations are "operated in connection with" one or more publicly supported organizations. To satisfy the "operated in connection with" relationship, Treasury regulations require that the supporting organization be responsive to, and significantly involved in the operations of, the publicly supported organization. This relationship is deemed to exist where the supporting organization meets both a "responsiveness test" and an "integral part test."[900] In general, the responsiveness test requires that the Type III supporting organization be responsive to the needs or demands of the publicly supported organizations. In general, the integral part test requires that the Type III supporting organization maintain significant involvement in the operations of one or more publicly supported organizations, and that such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides.

There are two alternative methods for satisfying the integral part test. The first alternative is to establish that (1) the activities engaged in for or on behalf of the publicly supported organization are activities to perform the functions of, or carry out the purposes of, such organizations; and (2) these activities, but for the involvement of the supporting organization, normally would be engaged in by the publicly supported organizations themselves.[901] Organizations that satisfy this "but for" test sometimes are referred to as

[897] *Id.*
[898] Treas. Reg. sec. 1.509(a)–4(h)(1).
[899] Treas. Reg. sec. 1.509(a)–4(h)(2).
[900] Treas. Reg. sec. 1.509(a)–4(i)(1).
[901] Treas. Reg. sec. 1.509(a)–4(i)(3)(ii).

"functionally integrated" Type III supporting organizations. The second method for satisfying the integral part test is to establish that: (1) the supporting organization pays substantially all of its income to or for the use of one or more publicly supported organizations;[902] (2) the amount of support received by one or more of the publicly supported organizations is sufficient to insure the attentiveness of the organization or organizations to the operations of the supporting organization (this is known as the "attentiveness requirement");[903] and (3) a significant amount of the total support of the supporting organization goes to those publicly supported organizations that meet the attentiveness requirement.[904]

### *Explanation of Provision*

Elsewhere in the Act, provision is made for new rules with respect to donor advised funds and supporting organizations. Many issues arise under current law with respect to such organizations, some of which are addressed by the Act and some of which would benefit from additional study. The provision provides that the Secretary of the Treasury shall undertake a study on the organization and operation of donor advised funds (as defined in section 4966(d)(2)) and of supporting organizations (organizations described in section 509(a)(3)). The study shall specifically consider (1) whether the amount and availability of the income, gift, or estate tax charitable deductions allowed for charitable contributions to sponsoring organizations (as defined in section 4966(d)(1)) of donor advised funds or to organizations described in section 509(a)(3) is appropriate in consideration of (i) the use of contributed assets (including the type, extent, and timing of such use) or (ii) the use of the assets of such organizations for the benefit of the person making the charitable contribution (or a person related to such person), (2) whether donor advised funds should be required to distribute for charitable purposes a specified amount (whether based on the income or assets of the fund) in order to ensure that the sponsoring organization with respect to the fund is operating consistent with the purposes or functions constituting the basis for its exemption under section 501 or its status as an organization described in section 509(a), (3) whether the retention by donors to donor advised funds or supporting organizations of rights or privileges with respect to amounts transferred to such organizations (including advisory rights or privileges with respect to the making of grants or the investment of assets) is consistent with the treatment of such transfers as completed gifts that qualify for an income, gift, or estate tax charitable deduction, and (4) whether any of the issues addressed above also raise issues with respect to other forms of charities or charitable donations.

---

[902] For this purpose, the IRS has defined the term "substantially all" of an organization's income to mean 85 percent or more. Rev. Rul. 76–208, 1976–1 C.B. 161.

[903] Although the regulations do not specify the requisite level of support in numerical or percentage terms, the IRS has suggested that grants that represent less than 10 percent of the beneficiary's support likely would be viewed as insufficient to ensure attentiveness. Gen. Couns. Mem. 36379 (August 15, 1975). As an alternative to satisfying the attentiveness standard by the foregoing method, a supporting organization may demonstrate attentiveness by showing that, in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. Treas. Reg. sec. 1.509(a)–4(i)(3)(iii)(b).

[904] Treas. Reg. sec. 1.509(a)–4(i)(3)(iii).

Not later than one year after the date of enactment (August 17, 2006) of this Act, the Secretary shall submit a report on the study, comment on any actions (audits, guidance, regulations, etc.) taken by the Secretary with respect to the issues discussed in the study, and make recommendations to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## 17. Improved accountability of donor advised funds (secs. 1231–1235 of the Act and secs. 170, 508, 2055, 2522, 4943, 4958, 6033, and new secs. 4966 and 4967 of the Code)

### *Present Law*

#### *Requirements for section 501(c)(3) tax-exempt status*

Charitable organizations, i.e., organizations described in section 501(c)(3), generally are exempt from Federal income tax and are eligible to receive tax deductible contributions. A charitable organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.[905] In order to qualify as operating primarily for a purpose described in section 501(c)(3), an organization must satisfy the following operational requirements: (1) the net earnings of the organization may not inure to the benefit of any person in a position to influence the activities of the organization; (2) the organization must operate to provide a public benefit, not a private benefit;[906] (3) the organization may not be operated primarily to conduct an unrelated trade or business;[907] (4) the organization may not engage in substantial legislative lobbying; and (5) the organization may not participate or intervene in any political campaign.

#### *Classification of section 501(c)(3) organizations*

Section 501(c)(3) organizations are classified either as "public charities" or "private foundations."[908] Private foundations generally are defined under section 509(a) as all organizations described in section 501(c)(3) other than an organization granted public charity status by reason of: (1) being a specified type of organization (i.e., churches, educational institutions, hospitals and certain other medical organizations, certain organizations providing assistance to colleges and universities, or a governmental unit); (2) receiving a substantial part of its support from governmental units

[905] Treas. Reg. sec. 1.501(c)(3)-1(c)(1). The Code specifies such purposes as religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. In general, an organization is organized and operated for charitable purposes if it provides relief for the poor and distressed or the underprivileged. Treas. Reg. sec. 1.501(c)(3)-1(d)(2).

[906] Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(ii).

[907] Treas. Reg. sec. 1.501(c)(3)-1(e)(1). Conducting a certain level of unrelated trade or business activity will not jeopardize tax-exempt status.

[908] Sec. 509(a). Private foundations are either private operating foundations or private non-operating foundations. In general, private operating foundations operate their own charitable programs in contrast to private non-operating foundations, which generally are grant-making organizations. Most private foundations are non-operating foundations.

or direct or indirect contributions from the general public; or (3) providing support to another section 501(c)(3) entity that is not a private foundation. In contrast to public charities, private foundations generally are funded from a limited number of sources (e.g., an individual, family, or corporation). Donors to private foundations and persons related to such donors together often control the operations of private foundations.

Because private foundations receive support from, and typically are controlled by, a small number of supporters, private foundations are subject to a number of anti-abuse rules and excise taxes not applicable to public charities.[909] For example, the Code imposes excise taxes on acts of "self-dealing" between disqualified persons (generally, an enumerated class of foundation insiders)[910] and a private foundation. Acts of self-dealing include, for example, sales or exchanges, or leasing, of property; lending of money; or the furnishing of goods, services, or facilities between a disqualified person and a private foundation.[911] In addition, private nonoperating foundations are required to pay out a minimum amount each year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization's exempt purposes, including reasonable and necessary administrative expenses.[912] Certain expenditures of private foundations are also subject to tax.[913] In general, taxable expenditures are expenditures: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility[914] with respect to the grant; or (5) for any non-charitable purpose. Additional excise taxes may also apply in the event a private foundation holds certain business interests ("excess business holdings")[915] or makes an investment that jeopardizes the foundation's exempt purposes.[916]

### *Supporting organizations*

#### *In general*

The Code provides that certain "supporting organizations" (in general, organizations that provide support to another section 501(c)(3) organization that is not a private foundation) are classified as public charities rather than private foundations.[917] To qualify as a supporting organization, an organization must meet all

[909] Secs. 4940–4945.
[910] See sec. 4946(a).
[911] Sec. 4941.
[912] Sec. 4942(g)(1)(A). A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's exempt purposes and certain amounts set-aside for exempt purposes. Sec. 4942(g)(1)(B) and 4942(g)(2).
[913] Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.
[914] In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).
[915] Sec. 4943.
[916] Sec. 4944.
[917] Sec. 509(a)(3).

three of the following tests: (1) it must be organized and at all times operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more "publicly supported organizations"[918] (the "organizational and operational tests");[919] (2) it must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations (the "relationship test");[920] and (3) it must not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations (the "lack of outside control test").[921]

To satisfy the relationship test, a supporting organization must hold one of three statutorily described close relationships with the supported organization. The organization must be: (1) operated, supervised, or controlled by a publicly supported organization (commonly referred to as "Type I" supporting organizations); (2) supervised or controlled in connection with a publicly supported organization ("Type II" supporting organizations); or (3) operated in connection with a publicly supported organization ("Type III" supporting organizations).[922]

*Type I supporting organizations*

In the case of supporting organizations that are operated, supervised, or controlled by one or more publicly supported organizations (Type I supporting organizations), one or more supported organizations must exercise a substantial degree of direction over the policies, programs, and activities of the supporting organization.[923] The relationship between the Type I supporting organization and the supported organization generally is comparable to that of a parent and subsidiary. The requisite relationship may be established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.[924]

*Type II supporting organizations*

Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations. Rather than the parent-subsidiary relationship characteristic of Type I organizations, the relationship between a Type II organization and its supported organizations is more analogous to a brother-sister relationship. In order to satisfy the Type II relationship requirement, generally there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations.[925] An organization generally is not considered to be "supervised or controlled

[918] In general, supported organizations of a supporting organization must be publicly supported charities described in sections 509(a)(1) or (a)(2).
[919] Sec. 509(a)(3)(A).
[920] Sec. 509(a)(3)(B).
[921] Sec. 509(a)(3)(C).
[922] Treas. Reg. sec. 1.509(a)-4(f)(2).
[923] Treas. Reg. sec. 1.509(a)-4(g)(1)(i).
[924] *Id.*
[925] Treas. Reg. sec. 1.509(a)-4(h)(1).

in connection with" a publicly supported organization merely because the supporting organization makes payments to the publicly supported organization, even if the obligation to make payments is enforceable under state law.[926]

*Type III supporting organizations*

Type III supporting organizations are "operated in connection with" one or more publicly supported organizations. To satisfy the "operated in connection with" relationship, Treasury regulations require that the supporting organization be responsive to, and significantly involved in the operations of, the publicly supported organization. This relationship is deemed to exist where the supporting organization meets both a "responsiveness test" and an "integral part test."[927] In general, the responsiveness test requires that the Type III supporting organization be responsive to the needs or demands of the publicly supported organizations. In general, the integral part test requires that the Type III supporting organization maintain significant involvement in the operations of one or more publicly supported organizations, and that such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides.

There are two alternative methods for satisfying the integral part test. The first alternative is to establish that (1) the activities engaged in for or on behalf of the publicly supported organization are activities to perform the functions of, or carry out the purposes of, such organizations; and (2) these activities, but for the involvement of the supporting organization, normally would be engaged in by the publicly supported organizations themselves.[928] Organizations that satisfy this "but for" test sometimes are referred to as "functionally integrated" Type III supporting organizations. The second method for satisfying the integral part test is to establish that: (1) the supporting organization pays substantially all of its income to or for the use of one or more publicly supported organizations;[929] (2) the amount of support received by one or more of the publicly supported organizations is sufficient to insure the attentiveness of the organization or organizations to the operations of the supporting organization (this is known as the "attentiveness requirement");[930] and (3) a significant amount of the total support of the supporting organization goes to those publicly supported organizations that meet the attentiveness requirement.[931]

---

[926] Treas. Reg. sec. 1.509(a)-4(h)(2).

[927] Treas. Reg. sec. 1.509(a)-4(i)(1).

[928] Treas. Reg. sec. 1.509(a)-4(i)(3)(ii).

[929] For this purpose, the IRS has defined the term "substantially all" of an organization's income to mean 85 percent or more. Rev. Rul. 76–208, 1976–1 C.B. 161.

[930] Although the regulations do not specify the requisite level of support in numerical or percentage terms, the IRS has suggested that grants that represent less than 10 percent of the beneficiary's support likely would be viewed as insufficient to ensure attentiveness. Gen. Couns. Mem. 36379 (August 15, 1975). As an alternative to satisfying the attentiveness standard by the foregoing method, a supporting organization may demonstrate attentiveness by showing that, in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. Treas. Reg. sec. 1.509(a)-4(i)(3)(iii)(b).

[931] Treas. Reg. sec. 1.509(a)-4(i)(3)(iii).

### *Charitable contributions*

Contributions to organizations described in section 501(c)(3) are deductible, subject to certain limitations, as an itemized deduction from Federal income taxes.[932] Such contributions also generally are deductible for estate and gift tax purposes.[933] However, if the taxpayer retains control over the assets transferred to charity, the transfer may not qualify as a completed gift for purposes of claiming an income, estate, or gift tax deduction.

Public charities enjoy certain advantages over private foundations regarding the deductibility of contributions. For example, contributions of appreciated capital gain property to a private foundation generally are deductible only to the extent of the donor's cost basis.[934] In contrast, contributions to public charities generally are deductible in an amount equal to the property's fair market value, except for gifts of inventory and other ordinary income property, short-term capital gain property, and tangible personal property the use of which is unrelated to the donee organization's exempt purpose. In addition, under present law, a taxpayer's deductible contributions generally are limited to specified percentages of the taxpayer's contribution base, which generally is the taxpayer's adjusted gross income for a taxable year. The applicable percentage limitations vary depending upon the type of property contributed and the classification of the donee organization. In general, contributions to non-operating private foundations are limited to a smaller percentage of the donor's contribution base (up to 30 percent) than contributions to public charities (up to 50 percent).[935]

In general, taxpayers who make contributions and claim a charitable deduction must satisfy recordkeeping and substantiation requirements.[936] The requirements vary depending on the type and value of property contributed. A deduction generally may be denied if the donor fails to satisfy applicable recordkeeping or substantiation requirements.

### *Intermediate sanctions (excess benefit transaction tax)*

The Code imposes excise taxes on excess benefit transactions between disqualified persons and public charities.[937] An excess benefit transaction generally is a transaction in which an economic benefit is provided by a public charity directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

For purposes of the excess benefit transaction rules, a disqualified person is any person in a position to exercise substantial influence over the affairs of the public charity at any time in the five-

---

[932] Sec. 170.

[933] Secs. 2055 and 2522.

[934] A special rule in section 170(e)(5) provides that taxpayer are allowed a deduction equal to the fair market value of certain contributions of appreciated, publicly traded stock contributed to a private foundation.

[935] Sec. 170(b).

[936] Sec. 170(f)(8).

[937] Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status. The tax also applies to transactions between disqualified persons and social welfare organizations (as described in section 501(c)(4)).

year period ending on the date of the transaction at issue.[938] Persons holding certain powers, responsibilities, or interests (e.g., officers, directors, or trustees) are considered to be in a position to exercise substantial influence over the affairs of the public charity.

An excess benefit transaction tax is imposed on the disqualified person and, in certain cases, on the organization managers, but is not imposed on the public charity. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected within a specified period. A tax of 10 percent of the excess benefit (not to exceed $10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.

***Community foundations***

Community foundations generally are broadly supported section 501(c)(3) public charities that make grants to other charitable organizations located within a community foundation's particular geographic area. Donors sometimes make contributions to a community foundation through transfers to a separate trust or fund, the assets of which are held and managed by a bank or investment company.

Certain community foundations are subject to special rules that permit them to treat the separate funds or trusts maintained by the community foundation as a single entity for tax purposes. This "single entity" status allows the community foundation to be classified as a public charity. One of the requirements that community foundations must meet is that funds maintained by the community foundation may not be subject by the donor to any material restrictions or conditions. The prohibition against material restrictions or conditions is designed to prevent a donor from encumbering a fund in a manner that prevents the community foundation from freely distributing the assets and income from it in furtherance of the community foundation's charitable purposes. Under Treasury regulations, whether a particular restriction or condition placed by the donor on the transfer of assets is material must be determined from all of the facts and circumstances of the transfer. The regulations set out some of the more significant facts and circumstances to be considered in making a determination, including: (1) whether the transferee public charity is the fee owner of the assets received; (2) whether the assets are held and administered by the public charity in a manner consistent with its own exempt purposes; (3) whether the governing body of the public charity has the ultimate authority and control over the assets and the income derived from them; and (4) whether the governing body of the public charity is independent from the donor. The regulations provide several nonadverse factors for determining whether a particular restriction or condition placed by the donor on the transfer of assets is material.

[938] Sec. 4958(f)(1). A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons.

In addition, the regulations list numerous factors and subfactors that indicate that the community foundation is prevented from freely and effectively employing the donated assets and the income thereon.

### *Donor advised funds*

Some charitable organizations (including community foundations) establish accounts to which donors may contribute and thereafter provide nonbinding advice or recommendations with regard to distributions from the fund or the investment of assets in the fund. Such accounts are commonly referred to as "donor advised funds". Donors who make contributions to charities for maintenance in a donor advised fund generally claim a charitable contribution deduction at the time of the contribution. Although sponsoring charities frequently permit donors (or other persons appointed by donors) to provide nonbinding recommendations concerning the distribution or investment of assets in a donor advised fund, sponsoring charities generally must have legal ownership and control of such assets following the contribution. If the sponsoring charity does not have such control (or permits a donor to exercise control over amounts contributed), the donor's contributions may not qualify for a charitable deduction, and, in the case of a community foundation, the contribution may be treated as being subject to a material restriction or condition by the donor.

In recent years, a number of financial institutions have formed charitable corporations for the principal purpose of offering donor advised funds, sometimes referred to as "commercial" donor advised funds. In addition, some established charities have begun operating donor advised funds in addition to their primary activities. The IRS has recognized several organizations that sponsor donor advised funds, including "commercial" donor advised funds, as section 501(c)(3) public charities. The term "donor advised fund" is not defined in statute or regulations.

Under the Katrina Emergency Tax Relief Act of 2005, certain of the above-described percentage limitations on contributions to public charities are temporarily suspended for purposes of certain "qualified contributions" to public charities. Under such Act, 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.

### *Excess business holdings of private foundations*

Private foundations are subject to tax on excess business holdings.[939] In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock

[939] Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership ("profits interest" is substituted for "voting stock" and "capital interest" for "nonvoting stock") and to other unincorporated enterprises (by substituting "beneficial interest" for "voting stock"). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.[940] This five-year period may be extended an additional five years in limited circumstances.[941] The excess business holdings rules do not apply to holdings in a functionally related business or to holdings in a trade or business at least 95 percent of the gross income of which is derived from passive sources.[942]

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation's applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

### *Explanation of Provision*

#### *Definition of a donor advised fund*

*General rule*

In general, the provision defines a "donor advised fund" as a fund or account that is: (1) separately identified by reference to contributions of a donor or donors (2) owned and controlled by a sponsoring organization and (3) with respect to which a donor (or any person appointed or designated by such donor (a "donor advisor") has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the separately identified fund or account by reason of the donor's status as a donor. All three prongs of the definition must be met in order for a fund or account to be treated as a donor advised fund.

The provision defines a "sponsoring organization" as an organization that: (1) is described in section 170(c)[943] (other than a governmental entity described in section 170(c)(1), and without regard to any requirement that the organization be organized in the United States);[944] (2) is not a private foundation (as defined in section 509(a)); and (3) maintains one or more donor advised funds.

The first prong of the definition requires that a donor advised fund be separately identified by reference to contributions of a donor or donors. A distinct fund or account of a sponsoring organization does not meet this prong of the definition unless the fund

[940] Sec. 4943(c)(6).
[941] Sec. 4943(c)(7).
[942] Sec. 4943(d)(3).
[943] Section 170(c) describes organizations to which charitable contributions that are deductible for income tax purposes can be made.
[944] See sec. 170(c)(2)(A).

or account refers to contributions of a donor or donors, such as by naming the fund after a donor, or by treating a fund on the books of the sponsoring organization as attributable to funds contributed by a specific donor or donors. Although a sponsoring organization's general fund is a "fund or account," such fund will not, as a general matter, be treated as a donor advised fund because the general funds of an organization typically are not separately identified by reference to contributions of a specific donor or donors; rather contributions are pooled anonymously within the general fund. Similarly, a fund or account of a sponsoring organization that is distinct from the organization's general fund and that pools contributions of multiple donors generally will not meet the first prong of the definition unless the contributions of specific donors are in some manner tracked and accounted for within the fund. Accordingly, if a sponsoring organization establishes a fund dedicated to the relief of poverty within a specific community, or a scholarship fund, and the fund attracts contributions from several donors but does not separately identify or refer to contributions of a donor or donors, the fund is not a donor advised fund even if a donor has advisory privileges with respect to the fund. However, a fund or account may not avoid treatment as a donor advised fund even though there is no formal recognition of such separate contributions on the books of the sponsoring organization if the fund or account operates as if contributions of a donor or donors are separately identified. The Secretary has the authority to look to the substance of an arrangement, and not merely its form. In addition, a fund or account may be treated as identified by reference to contributions of a donor or donors if the reference is to persons related to a donor. For example, if a husband made contributions to a fund or account that in turn is named after the husband's wife, the fund is treated as being separately identified by reference to contributions of a donor.

The second prong of the definition provides that the fund be owned and controlled by a sponsoring organization. To the extent that a donor or person other than the sponsoring organization owns or controls amounts deposited to a sponsoring organization, a fund or account is not a donor advised fund. (In cases where a donor retains control of an amount provided to a sponsoring organization, there may not be a completed gift for purposes of the charitable contribution deduction.)

The third prong of the definition provides that with respect to a fund or account of a sponsoring organization, a donor or donor advisor has or reasonably expects to have advisory privileges with respect to the distribution or investment of amounts held in the fund or account by reason of a donor's status as a donor. Advisory privileges are distinct from a legal right or obligation. For example, if a donor executes a gift agreement with a sponsoring organization that specifies certain enforceable rights of the donor with respect to a gift, the donor will not be treated as having "advisory privileges" due to such enforceable rights for purposes of the donor advised fund definition.

The presence of an advisory privilege may be evident through a written document that describes an arrangement between the donor or donor adviser and the sponsoring organization whereby a

donor or donor advisor may provide advice to the sponsoring organization about the investment or distribution of amounts held by a sponsoring organization, even if such privileges are not exercised. The presence of an advisory privilege also may be evident through the conduct of a donor or donor advisor and the sponsoring organization. For example, even in the absence of a writing, if a donor regularly provides advice to a sponsoring organization and the sponsoring organization regularly considers such advice, the donor has advisory privileges under the provision. Even if advisory privileges do not exist at the time of a contribution, later acts by the donor (through the provision of advice) and by the sponsoring organization (through the regular consideration of advice) may establish advisory privileges subsequent to the time of the contribution. For example, if a past donor of $100,000 telephones a sponsoring organization and states that he would like the sponsoring organization to distribute $10,000 to an organization described in section 170(b)(1)(A), although the mere act of providing advice does not establish an advisory privilege, if the sponsoring organization distributed the $10,000 to the organization specified by the donor in consideration of the donor's advice, and reinforced the donor in some manner that future advice similarly would be considered, advisory privileges (or the reasonable expectation thereof) might be established. However, the mere provision of advice by a donor or donor advisor does not mean the donor or donor advisor has advisory privileges. For example, a donor's singular belief that he or she has advisory privileges with respect to the contribution does not establish an advisory privilege—there must be some reciprocity on the part of the sponsoring organization.

A person reasonably expects to have advisory privileges if both the donor or donor advisor and the sponsoring organization have reason to believe that the donor or donor advisor will provide advice and that the sponsoring organization generally will consider it. Thus, a person reasonably may expect to have advisory privileges even in the absence of the actual provision of advice. However, a donor's expectation of advisory privileges is not reasonable unless it is reinforced in some manner by the conduct of the sponsoring organization. If, at the time of the contribution, the sponsoring organization had no knowledge that the donor had an expectation of advisory privileges, or no intention of considering any advice provided by the donor, then the donor does not have a reasonable expectation of advisory privileges. Ultimately, the presence or absence of advisory privileges (or a reasonable expectation thereof) depends upon the facts and circumstances, which in turn depend upon the conduct (including any agreement) of both the donor or donor advisor and the sponsoring organization with respect to the making and consideration of advice.

A further requirement of the third prong is that the reasonable expectation of advisory privileges is by reason of the donor's status as a donor. Under this requirement, if a donor's reasonable expectation of advisory privileges is due solely to the donor's service to the organization, for example, by reason of the donor's position as an officer, employee, or director of the sponsoring organization, then the third prong of the definition is not satisfied. For instance, in general, a donor that is a member of the board of directors of

the sponsoring organization may provide advice in his or her capacity as a board member with respect to the distribution or investment of amounts in a fund to which the board member contributed. However, if by reason of such donor's contribution to such fund, the donor secured an appointment on a committee of the sponsoring organization that advises how to distribute or invest amounts in such fund, the donor may have a reasonable expectation of advisory privileges, notwithstanding that the donor is an officer, employee, or director of the sponsoring organization.

The third prong of the definition is applicable to a donor or any person appointed or designated by such donor (the donor advisor). For purposes of this prong, a person appointed or designated by a donor advisor is treated as being appointed or designated by a donor. In addition, for purposes of any exception to the definition of a donor advised fund provided under the provision, to the extent a donor recommends to a sponsoring organization the selection of members of a committee that will advise as to distributions or investments of amounts in a fund or account of such sponsoring organization, such members are not treated as appointed or designated by the donor if the recommendation of such members by such donor is based on objective criteria related to the expertise of the member. For example, if a donor recommends that a committee of a sponsoring organization that will provide advice regarding scholarship grants for the advancement of science at local secondary schools should consist of persons who are the heads of the science departments of such schools, then the donor generally would not be considered to have appointed or designated such persons, i.e., they would not be treated as donor advisors.

*Exceptions*

A donor advised fund does not include a fund or account that makes distributions only to a single identified organization or governmental entity. For example, an endowment fund owned and controlled by a sponsoring organization that is held exclusively to for the benefit of such sponsoring organization is not a donor advised fund even if the fund is named after its principal donor and such donor has advisory privileges with respect to the distribution of amounts held in the fund to such sponsoring organization. Accordingly, a donor that contributes to a university for purposes of establishing a fund named after the donor that exclusively supports the activities of the university is not a donor advised fund even if the donor has advisory privileges regarding the distribution or investment of amounts in the fund.

A donor advised fund also does not include a fund or account with respect to which a donor or donor advisor provides advice as to which individuals receive grants for travel, study, or other similar purposes, provided that (1) the donor's or donor advisor's advisory privileges are performed exclusively by such donor or donor advisor in such person's capacity as a member of a committee all of the members of which are appointed by the sponsoring organization, (2) no combination of a donor or donor advisor or persons related to such persons, control, directly or indirectly, such committee, and (3) all grants from such fund or account are awarded on an objective and nondiscriminatory basis pursuant to a proce-

dure approved in advance by the board of directors of the sponsoring organization, and such procedure is designed to ensure that all such grants meet the requirements described in paragraphs (1), (2), or (3) of section 4945(g) (concerning grants to individuals by private foundations).

In addition, the Secretary may exempt a fund or account from treatment as a donor advised fund if such fund or account is advised by a committee not directly or indirectly controlled by a donor, donor advisor, or persons related to a donor or donor advisor. For such purposes, it is intended that indirect control includes the ability to exercise effective control. For example, if a donor, a donor advisor, and an attorney hired by the donor to provide advice regarding the donor's contributions constitute three of the five members of such a committee, the committee would be treated as being controlled indirectly by the donor for purposes of such an exception. Board membership alone does not establish direct or indirect control. In general, under this authority, the Secretary may establish rules regarding committee advised funds generally that, if followed, would result in the fund not being treated as a donor advised fund. The Secretary also may establish rules excepting certain types of committee-advised funds, such as a fund established exclusively for disaster relief, from the donor advised fund definition.

The provision also provides that the Secretary may exempt a fund or account from treatment as a donor advised fund if such fund or account benefits a single identified charitable purpose.

### *Deductibility of contributions to a sponsoring organization for maintenance in a donor advised fund*

#### *Contributions to certain sponsoring organizations for maintenance in a donor advised fund not eligible for a charitable deduction*

Under the provision, contributions to a sponsoring organization for maintenance in a donor advised fund are not eligible for a charitable deduction for income tax purposes if the sponsoring organization is a veterans' organization described in section 170(c)(3), a fraternal society described in section 170(c)(4), or a cemetery company described in section 170(c)(5); for gift tax purposes if the sponsoring organization is a fraternal society described in section 2522(a)(3) or a veterans' organization described in section 2522(a)(4); or for estate tax purposes if the sponsoring organization is a fraternal society described in section 2055(a)(3) or a veterans' organization described in section 2055(a)(4). In addition, contributions to a sponsoring organization for maintenance in a donor advised fund are not eligible for a charitable deduction for income, gift, or estate tax purposes if the sponsoring organization is a Type III supporting organization (other than a functionally integrated Type III supporting organization). A functionally integrated Type III supporting organization is a Type III supporting organization that is not required under regulations established by the Secretary to make payments to supported organizations due to the activities of the orga-

nization related to performing the functions of, or carrying out the purposes of, such supported organizations.[945]

*Additional substantiation requirements*

In addition to satisfying present-law substantiation requirements under section 170(f), a donor must obtain, with respect to each charitable contribution to a sponsoring organization to be maintained in a donor advised fund, a contemporaneous written acknowledgment from the sponsoring organization providing that the sponsoring organization has exclusive legal control over the assets contributed.

***Excess business holdings***

The excess business holdings rules of section 4943 are applied to donor advised funds. In applying such rules, the term disqualified person means, with respect to a donor advised fund, a donor, donor advisor, a member of the family of a donor or donor advisor, or a 35 percent controlled entity of any such person. Transition rules apply to the present holdings of a donor advised fund similar to those of section 4943(c)(4)–(6).

***Automatic excess benefit transactions, disqualified persons, taxable distributions, and more than incidental benefit***

*Automatic excess benefit transactions*

Under the provision, any grant, loan, compensation, or other similar payment from a donor advised fund to a person that with respect to such fund is a donor, donor advisor, or a person related[946] to a donor or donor advisor automatically is treated as an excess benefit transaction under section 4958, with the entire amount[947] paid to any such person treated as the amount of the excess benefit. Other similar payments include payments in the nature of a grant, loan, or payment of compensation, such as an expense reimbursement. Other similar payments do not include, for example, a payment pursuant to bona fide sale or lease of property, which instead are subject to the general rules of section 4958 under the special disqualified person rule of the provision described below. Also as described below, payment by a sponsoring organization of, for example, compensation to a person who both is a donor with respect to a donor advised fund of the sponsoring organization and a service provider with respect to the sponsoring organization generally, will not be subject to the automatic excess benefit transaction rule of the provision unless the payment (of a grant, loan, compensation, or other similar payment) properly is viewed as a payment from the donor advised fund and not from the sponsoring organization.

Any amount repaid as a result of correcting an excess benefit transaction shall not be held in any donor advised fund.

---

[945] The current such regulation is Treasury regulation section 1.509(a)–4(i)(3)(ii).

[946] For purposes of the provision, a person is treated as related to another person if (1) such person bears a relationship to such other person similar to the relationships described in sections 4958(f)(1)(B) and 4958(f)(1)(C).

[947] The requirement of the provision that the entire amount of the payment be treated as the amount of the excess benefit differs from the generally applicable rule of section 4958, which provides that the excess benefit is the amount by which the value of the economic benefit provided exceeds the value of the consideration received.

*Disqualified persons*

In general, the provision provides that donors and donor advisors with respect to a donor advised fund (as well as persons related to a donor or donor advisor) are treated as disqualified persons under section 4958 with respect to transactions with such donor advised fund (though not necessarily with respect to transactions with the sponsoring organization more generally). For example, if a donor to a donor advised fund purchased securities from the fund, the purchase is subject to the rules of section 4958 because, under the provision, the donor is a disqualified person with respect to the fund. Thus, if as a result of the purchase, the donor receives an excess benefit as defined under generally applicable section 4958 rules, then the donor is subject to tax under such rules. If, as generally would be the case, the purchase was of securities that were contributed by the donor, a factor that may indicate the presence of an excess benefit is if the amount paid by the donor to acquire the securities is less than the amount the donor claimed the securities were worth for purposes of any charitable contribution deduction of the donor. In addition, if a donor advised fund distributes securities to the sponsoring organization of the fund prior to purchase by the donor, consideration should be given to whether the distribution to the sponsoring organization prior to the purchase was intended to circumvent the disqualified person rule of the provision. If so, such a distribution may be disregarded with the result that the purchase is treated as being made from the donor advised fund and not from the sponsoring organization.

As a factual matter, a person who is a donor to a donor advised fund and thus a disqualified person with respect to the fund also may be a service provider with respect to the sponsoring organization. In general, under the provision, as under present law, the sponsoring organization's transactions with the service provider are not subject to the rules of section 4958 unless the service provider is a disqualified person with respect to the sponsoring organization (e.g., if the service provider serves on the board of directors of the sponsoring organization), or unless the transaction is not properly viewed as a transaction with the sponsoring organization but in substance is a transaction with the service provider's donor advised fund. If the transaction properly is viewed as a transaction with the donor advised fund of a sponsoring organization, then the transaction is subject to the rules of section 4958, and, as described above, if the transaction involves payment of a grant, loan, compensation, or other similar payment, then the transaction is subject to the special automatic excess benefit transaction rule of the provision. For example, if a sponsoring organization pays an amount as part of a service contract to a service provider (a bank, for example) who also is a donor to a donor advised fund of the sponsoring organization, and such amounts reasonably are charged uniformly in whole or in part as routine fees to all of the sponsoring organization's donor advised funds, the transaction generally is considered to be between the sponsoring organization and the service provider in such service provider's capacity as a service provider. The transaction is not considered to be a transaction between a donor advised fund and the service provider even though an amount paid

under the contract was charged to a donor advised fund of the service provider.

The provision provides that an investment advisor (as well as persons related to the investment advisor) is treated as a disqualified person under section 4958 with respect to the sponsoring organization. Under the provision, the term "investment advisor" means, with respect to any sponsoring organization, any person (other than an employee of the sponsoring organization) compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds (including pools of assets all or part of which are attributed to donor advised funds) owned by the sponsoring organization.

*Taxable distributions*

Under the provision, certain distributions from a donor advised fund are subject to tax. A "taxable distribution" is any distribution from a donor advised fund to (1) any natural person; (2) to any other person for any purpose other than one specified in section 170(c)(2)(B) (generally, a charitable purpose) or, if for a charitable purpose, the sponsoring organization does not exercise expenditure responsibility with respect to the distribution in accordance with section 4945(h). The expenditure responsibility rules generally require that an organization exert all reasonable efforts and establish adequate procedures to see that the distribution is spent solely for the purposes for which it was made, to obtain full and complete reports from the distributee on how the funds are spent, and to make full and detailed reports with respect to such expenditures to the Secretary. A taxable distribution does not in any case include a distribution to (1) an organization described in section 170(b)(1)(A)[948] (other than to a disqualified supporting organization);[949] (2) the sponsoring organization of such donor advised fund; or (3) to another donor advised fund.[950]

In the event of a taxable distribution, an excise tax equal to 20 percent of the amount of the distribution is imposed against the sponsoring organization. In addition, an excise tax equal to five percent of the amount of the distribution is imposed against any manager of the sponsoring organization (defined in a manner simi-

[948] For purposes of the requirement that a distribution be "to" an organization described in section 170(b)(1)(A), in general, it is intended that rules similar to the rules of Treasury regulation section 53.4945–5(a)(5) apply. Under such regulations, for purposes of determining whether a grant by a private foundation is "to" an organization described in section 509(a)(1), (2), or (3) and so not a taxable expenditure under section 4945, a foreign organization that otherwise is not a section 509(a)(1), (2), or (3) organization is considered as such if the private foundation makes a good faith determination that the grantee is such an organization. Similarly, under the provision, if a sponsoring organization makes a good faith determination (under standards similar to those currently applicable for private foundations) that a distributee organization is an organization described in section 170(b)(1)(A) (other than a disqualified supporting organization), then a distribution to such organization is not considered a taxable distribution.

[949] Under the provision, the term disqualified supporting organization means, with respect to any distribution from a donor advised fund: (1) a Type III supporting organization, other than a functionally integrated Type III supporting organization; and (2) any other supporting organization if either (a) the donor or donor advisor of the distributing donor advised fund directly or indirectly controls a supported organization of the supporting organization, or (b) the Secretary determines by regulations that a distribution to such supporting organization otherwise is inappropriate.

[950] Under the provision, sponsoring organizations may make grants to natural persons from amounts not held in donor advised funds and may establish scholarship funds that are not donor advised funds. A donor may choose to make a contribution directly to such a scholarship fund (or advise that a donor advised fund make a distribution to such a scholarship fund).

lar to the term "foundation manager" under section 4945) who knowingly approved the distribution, not to exceed $10,000 with respect to any one taxable distribution. The taxes on taxable distributions are subject to abatement under generally applicable present law rules.

*More than incidental benefit*

Under the provision, if a donor, a donor advisor, or a person related to a donor or donor advisor of a donor advised fund provides advice as to a distribution that results in any such person receiving, directly or indirectly, a more than incidental benefit, an excise tax equal to 125 percent of the amount of such benefit is imposed against the person who advised as to the distribution, and against the recipient of the benefit. Persons subject to the tax are jointly and severally liable for the tax. In addition, if a manager of the sponsoring organization (defined in a manner similar to the term "foundation manager" under section 4945) agreed to the making of the distribution, knowing that the distribution would confer a more than incidental benefit on a donor, a donor advisor, or a person related to a donor or donor advisor, the manager is subject to an excise tax equal to 10 percent of the amount of such benefit, not to exceed $10,000. The taxes on more than incidental benefit are subject to abatement under generally applicable present law rules.

In general, under the provision, there is a more than incidental benefit if, as a result of a distribution from a donor advised fund, a donor, donor advisor, or related person with respect to such fund receives a benefit that would have reduced (or eliminated) a charitable contribution deduction if the benefit was received as part of the contribution to the sponsoring organization. If, for example, a donor advises a that a distribution from the donor's donor advised fund be made to the Girl Scouts of America, and the donor's daughter is a member of a local unit of the Girl Scouts of America, the indirect benefit the donor receives as a result of such contribution is considered incidental under the provision, as it generally would not have reduced or eliminated the donor's deduction if it had been received as part of a contribution by donor to the sponsoring organization.[951]

### *Reporting and disclosure*

The provision requires each sponsoring organization to disclose on its information return: (1) the total number of donor advised funds it owns; (2) the aggregate value of assets held in those funds at the end of the organization's taxable year; and (3) the aggregate contributions to and grants made from those funds during the year.

In addition, when seeking recognition of its tax-exempt status, a sponsoring organization must disclose whether it intends to maintain donor advised funds. It is intended that the organization must provide information regarding its planned operation of such funds, including, for example, a description of procedures it intends to use to: (1) communicate to donors and donor advisors that assets held in donor advised funds are the property of the sponsoring organiza-

[951] *See, e.g.,* Rev. Rul. 80–77, 1980–1 C.B. 56; Rev. Proc. 90–12, 1990–1 C.B. 471.

tion; and (2) ensure that distributions from donor advised funds do not result in more than incidental benefit to any person.

### *Effective Date*

The provision generally is effective for taxable years beginning after the date of enactment (August 17, 2006). The provision relating to excess benefit transactions is effective for transactions occurring after the date of enactment. Information return requirements are effective for taxable years ending after the date of enactment. The requirements concerning disclosures on an organization's application for tax exemption are effective for organizations applying for recognition of exempt status after the date of enactment. Requirements relating to charitable contributions to donor advised funds are effective for contributions made after 180 days from the date of enactment.

## 18. Improved accountability of supporting organizations (secs. 1241–1245 of the Act and secs. 509, 4942, 4943, 4945, 4958, and 6033 of the Code)

### *Present Law*

#### *Requirements for section 501(c)(3) tax-exempt status*

Charitable organizations, i.e., organizations described in section 501(c)(3), generally are exempt from Federal income tax and are eligible to receive tax deductible contributions. A charitable organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.[952] In order to qualify as operating primarily for a purpose described in section 501(c)(3), an organization must satisfy the following operational requirements: (1) the net earnings of the organization may not inure to the benefit of any person in a position to influence the activities of the organization; (2) the organization must operate to provide a public benefit, not a private benefit;[953] (3) the organization may not be operated primarily to conduct an unrelated trade or business;[954] (4) the organization may not engage in substantial legislative lobbying; and (5) the organization may not participate or intervene in any political campaign.

Section 501(c)(3) organizations (with certain exceptions) are required to seek formal recognition of tax-exempt status by filing an application with the IRS (Form 1023). In response to the application, the IRS issues a determination letter or ruling either recognizing the applicant as tax-exempt or not.

In general, organizations exempt from Federal income tax under section 501(a) are required to file an annual information return with the IRS.[955] Under present law, the information return requirement does not apply to several categories of exempt organiza-

[952] Treas. Reg. sec. 1.501(c)(3)–1(c)(1). The Code specifies such purposes as religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. In general, an organization is organized and operated for charitable purposes if it provides relief for the poor and distressed or the underprivileged. Treas. Reg. sec. 1.501(c)(3)–1(d)(2).

[953] Treas. Reg. sec. 1.501(c)(3)–1(d)(1)(ii).

[954] Treas. Reg. sec. 1.501(c)(3)–1(e)(1). Conducting a certain level of unrelated trade or business activity will not jeopardize tax-exempt status.

[955] Sec. 6033(a)(1).

tions. Organizations exempt from the filing requirement include organizations (other than private foundations), the gross receipts of which in each taxable year normally are not more than $25,000.[956]

### *Classification of section 501(c)(3) organizations*

#### *In general*

Section 501(c)(3) organizations are classified either as "public charities" or "private foundations."[957] Private foundations generally are defined under section 509(a) as all organizations described in section 501(c)(3) other than an organization granted public charity status by reason of: (1) being a specified type of organization (i.e., churches, educational institutions, hospitals and certain other medical organizations, certain organizations providing assistance to colleges and universities, or a governmental unit); (2) receiving a substantial part of its support from governmental units or direct or indirect contributions from the general public; or (3) providing support to another section 501(c)(3) entity that is not a private foundation. In contrast to public charities, private foundations generally are funded from a limited number of sources (e.g., an individual, family, or corporation). Donors to private foundations and persons related to such donors together often control the operations of private foundations.

Because private foundations receive support from, and typically are controlled by, a small number of supporters, private foundations are subject to a number of anti-abuse rules and excise taxes not applicable to public charities.[958] For example, the Code imposes excise taxes on acts of "self-dealing" between disqualified persons (generally, an enumerated class of foundation insiders)[959] and a private foundation. Acts of self-dealing include, for example, sales or exchanges, or leasing, of property; lending of money; or the furnishing of goods, services, or facilities between a disqualified person and a private foundation.[960] In addition, private nonoperating foundations are required to pay out a minimum amount each year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization's exempt purposes, including reasonable and necessary administrative expenses.[961] Certain expenditures of private foundations are also subject to tax.[962] In general, taxable expenditures are expenditures: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain require-

---

[956] Sec. 6033(a)(2); Treas. Reg. sec. 1.6033–2(a)(2)(i); Treas. Reg. sec. 1.6033–2(g)(1). Section 6033(a)(2)(A)(ii) provides a $5,000 annual gross receipts exception from the annual reporting requirements for certain exempt organizations. In Announcement 82–88, 1982–25 I.R.B. 23, the IRS exercised its discretionary authority under section 6033 to increase the gross receipts exception to $25,000, and enlarge the category of exempt organizations that are not required to file Form 990.

[957] Sec. 509(a). Private foundations are either private operating foundations or private non-operating foundations. In general, private operating foundations operate their own charitable programs in contrast to private non-operating foundations, which generally are grant-making organizations. Most private foundations are non-operating foundations.

[958] Secs. 4940–4945.

[959] See sec. 4946(a).

[960] Sec. 4941.

[961] Sec. 4942(g)(1)(A). A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's exempt purposes and certain amounts set-aside for exempt purposes. Sec. 4942(g)(1)(B) and 4942(g)(2).

[962] Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

ments are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility[963] with respect to the grant; or (5) for any non-charitable purpose. Additional excise taxes may apply in the event a private foundation holds certain business interests ("excess business holdings")[964] or makes an investment that jeopardizes the foundation's exempt purposes.[965]

Public charities also enjoy certain advantages over private foundations regarding the deductibility of contributions. For example, contributions of appreciated capital gain property to a private foundation generally are deductible only to the extent of the donor's cost basis.[966] In contrast, contributions to public charities generally are deductible in an amount equal to the property's fair market value, except for gifts of inventory and other ordinary income property, short-term capital gain property, and tangible personal property the use of which is unrelated to the donee organization's exempt purpose. In addition, under present law, a taxpayer's deductible contributions generally are limited to specified percentages of the taxpayer's contribution base, which generally is the taxpayer's adjusted gross income for a taxable year. The applicable percentage limitations vary depending upon the type of property contributed and the classification of the donee organization. In general, contributions to non-operating private foundations are limited to a smaller percentage of the donor's contribution base (up to 30 percent) than contributions to public charities (up to 50 percent).[967]

*Supporting organizations (section 509(a)(3))*

The Code provides that certain "supporting organizations" (in general, organizations that provide support to another section 501(c)(3) organization that is not a private foundation) are classified as public charities rather than private foundations.[968] To qualify as a supporting organization, an organization must meet all three of the following tests: (1) it must be organized and at all times operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more "publicly supported organizations"[969] (the "organizational and operational tests");[970] (2) it must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations (the "relationship test");[971] and (3) it must not be controlled directly or indirectly by one or more disqualified persons (as defined

[963] In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

[964] Sec. 4943.

[965] Sec. 4944.

[966] A special rule in section 170(e)(5) provides that taxpayer are allowed a deduction equal to the fair market value of certain contributions of appreciated, publicly traded stock contributed to a private foundation.

[967] Sec. 170(b).

[968] Sec. 509(a)(3).

[969] In general, supported organizations of a supporting organization must be publicly supported charities described in sections 509(a)(1) or (a)(2).

[970] Sec. 509(a)(3)(A).

[971] Sec. 509(a)(3)(B).

in section 4946) other than foundation managers and other than one or more publicly supported organizations (the "lack of outside control test").[972]

To satisfy the relationship test, a supporting organization must hold one of three statutorily described close relationships with the supported organization. The organization must be: (1) operated, supervised, or controlled by a publicly supported organization (commonly referred to as "Type I" supporting organizations); (2) supervised or controlled in connection with a publicly supported organization ("Type II" supporting organizations); or (3) operated in connection with a publicly supported organization ("Type III" supporting organizations).[973]

*Type I supporting organizations*

In the case of supporting organizations that are operated, supervised, or controlled by one or more publicly supported organizations (Type I supporting organizations), one or more supported organizations must exercise a substantial degree of direction over the policies, programs, and activities of the supporting organization.[974] The relationship between the Type I supporting organization and the supported organization generally is comparable to that of a parent and subsidiary. The requisite relationship may be established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.[975]

*Type II supporting organizations*

Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations. Rather than the parent-subsidiary relationship characteristic of Type I organizations, the relationship between a Type II organization and its supported organizations is more analogous to a brother-sister relationship. In order to satisfy the Type II relationship requirement, generally there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations.[976] An organization generally is not considered to be "supervised or controlled in connection with" a publicly supported organization merely because the supporting organization makes payments to the publicly supported organization, even if the obligation to make payments is enforceable under state law.[977]

*Type III supporting organizations*

Type III supporting organizations are "operated in connection with" one or more publicly supported organizations. To satisfy the "operated in connection with" relationship, Treasury regulations require that the supporting organization be responsive to, and signifi-

[972] Sec. 509(a)(3)(C).
[973] Treas. Reg. sec. 1.509(a)–4(f)(2).
[974] Treas. Reg. sec. 1.509(a)–4(g)(1)(i)
[975] *Id.*
[976] Treas. Reg. sec. 1.509(a)–4(h)(1).
[977] Treas. Reg. sec. 1.509(a)–4(h)(2).

cantly involved in the operations of, the publicly supported organization. This relationship is deemed to exist where the supporting organization meets both a "responsiveness test" and an "integral part test."[978]

In general, the responsiveness test requires that the Type III supporting organization be responsive to the needs or demands of the publicly supported organizations. The responsiveness test may be satisfied in one of two ways.[979] First, the supporting organization may demonstrate that: (1)(a) one or more of its officers, directors, or trustees are elected or appointed by the officers, directors, trustees, or membership of the supported organization; (b) one or more members of the governing bodies of the publicly supported organizations are also officers, directors, or trustees of the supporting organization; or (c) the officers, directors, or trustees of the supporting organization maintain a close continuous working relationship with the officers, directors, or trustees of the publicly supported organizations; and (2) by reason of such arrangement, the officers, directors, or trustees of the supported organization have a significant voice in the investment policies of the supporting organization, the timing and manner of making grants, the selection of grant recipients by the supporting organization, and otherwise directing the use of the income or assets of the supporting organization.[980] Alternatively, the responsiveness test may be satisfied if the supporting organization is a charitable trust under state law, each specified supported organization is a named beneficiary under the trust's governing instrument, and the beneficiary organization has the power to enforce the trust and compel an accounting under state law.[981]

In general, the integral part test requires that the Type III supporting organization maintain significant involvement in the operations of one or more publicly supported organizations, and that such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides. There are two alternative methods for satisfying the integral part test. The first alternative is to establish that (1) the activities engaged in for or on behalf of the publicly supported organization are activities to perform the functions of, or carry out the purposes of, such organizations; and (2) these activities, but for the involvement of the supporting organization, normally would be engaged in by the publicly supported organizations themselves.[982] Organizations that satisfy this "but for" test sometimes are referred to as "functionally integrated" Type III supporting organizations. The second method for satisfying the integral part test is to establish that: (1) the supporting organization pays substantially all of its income to or for the use of one or more publicly supported organizations;[983] (2) the amount of support received by one or more of the

[978] Treas. Reg. sec. 1.509(a)–4(i)(1).

[979] For an organization that was supporting or benefiting one or more publicly supported organizations before November 20, 1970, additional facts and circumstances, such as an historic and continuing relationship between organizations, also may be taken into consideration to establish compliance with either of the responsiveness tests. Treas. Reg. sec. 1.509(a)–4(i)(1)(ii).

[980] Treas. Reg. sec. 1.509(a)–4(i)(2)(ii).

[981] Treas. Reg. sec. 1.509(a)–4(i)(2)(iii).

[982] Treas. Reg. sec. 1.509(a)–4(i)(3)(ii).

[983] For this purpose, the IRS has defined the term "substantially all" of an organization's income to mean 85 percent or more. Rev. Rul. 76–208, 1976–1 C.B. 161.

publicly supported organizations is sufficient to insure the attentiveness of the organization or organizations to the operations of the supporting organization (this is known as the "attentiveness requirement");[984] and (3) a significant amount of the total support of the supporting organization goes to those publicly supported organizations that meet the "attentiveness requirement."[985]

### *Intermediate sanctions (excess benefit transaction tax)*

The Code imposes excise taxes on excess benefit transactions between disqualified persons and public charities.[986] An excess benefit transaction generally is a transaction in which an economic benefit is provided by a public charity directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

For purposes of the excess benefit transaction rules, a disqualified person is any person in a position to exercise substantial influence over the affairs of the public charity at any time in the five-year period ending on the date of the transaction at issue.[987] Persons holding certain powers, responsibilities, or interests (e.g., officers, directors, or trustees) are considered to be in a position to exercise substantial influence over the affairs of the public charity.

An excess benefit transaction tax is imposed on the disqualified person and, in certain cases, on the organization managers, but is not imposed on the public charity. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected within a specified period. A tax of 10 percent of the excess benefit (not to exceed $10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.

### *Excess business holdings of private foundations*

Private foundations are subject to tax on excess business holdings.[988] In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualifi-

---

[984] Although the regulations do not specify the requisite level of support in numerical or percentage terms, the IRS has suggested that grants that represent less than 10 percent of the beneficiary's support likely would be viewed as insufficient to ensure attentiveness. Gen. Couns. Mem. 36379 (August 15, 1975). As an alternative to satisfying the attentiveness standard by the foregoing method, a supporting organization may demonstrate attentiveness by showing that, in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. Treas. Reg. sec. 1.509(a)–4(i)(3)(iii)(b).

[985] Treas. Reg. sec. 1.509(a)–4(i)(3)(iii).

[986] Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status. The tax also applies to transactions between disqualified persons and social welfare organizations (as described in section 501(c)(4)).

[987] Sec. 4958(f)(1). A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons.

[988] Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

fied persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership ("profits interest" is substituted for "voting stock" and "capital interest" for "nonvoting stock") and to other unincorporated enterprises (by substituting "beneficial interest" for "voting stock"). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.[989] This five-year period may be extended an additional five years in limited circumstances.[990] The excess business holdings rules do not apply to holdings in a functionally related business or to holdings in a trade or business at least 95 percent of the gross income of which is derived from passive sources.[991]

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation's applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

### *Explanation of Provision*

#### *Provisions relating to all supporting organizations (Type I, Type II, and Type III)*

*Automatic excess benefit transactions*

Under the provision, if a supporting organization (Type I, Type II, or Type III) makes a grant, loan, payment of compensation, or other similar payment to a substantial contributor (or person related to the substantial contributor) of the supporting organization, for purposes of the excess benefit transaction rules (sec. 4958), the substantial contributor is treated as a disqualified person and the payment is treated automatically as an excess benefit transaction with the entire amount of the payment treated as the excess benefit.[992] Accordingly, the substantial contributor is subject to an initial tax of 25 percent of the amount of the payment under section 4958(a)(1) and an organization manager that participated in the making of the payment, knowing that the payment was a grant, loan, payment of compensation, or other similar payment to a substantial contributor, is subject to a tax of 10 percent of the amount of the payment under section 4958(a)(2). The second tier taxes and other rules of section 4958 also apply to such payments. Other similar payments include payments in the nature of a grant, loan, or payment of compensation, such as an expense reimbursement.

[989] Sec. 4943(c)(6).
[990] Sec. 4943(c)(7).
[991] Sec. 4943(d)(3).
[992] The requirement of the provision that the entire amount of the payment be treated as the amount of the excess benefit differs from the generally applicable rule of section 4958, which provides that the excess benefit is the amount by which the value of the economic benefit provided exceeds the value of the consideration received.

Other similar payments do not include, for example, a payment made pursuant to a bona fide sale or lease of property with a substantial contributor. Such payments are subject to the general rules of section 4958 if the substantial contributor meets the definition of a disqualified person under section 4958(f), but are not subject to the automatic excess benefit transaction rule of the provision. The provision applies to payments by a supporting organization to a substantial contributor but not to payments by a substantial contributor to a supporting organization.

Under the provision, a substantial contributor means any person who contributed or bequeathed an aggregate amount of more than $5,000 to the organization, if such amount is more than two percent of the total contributions and bequests received by the organization before the close of the taxable year of the organization in which the contribution or bequest is received by the organization from such person. In the case of a trust, a substantial contributor also includes the creator of the trust. A substantial contributor does not include a public charity (other than a supporting organization). Under the provision, mechanical rules similar to the rules that apply in determining whether a person is a substantial contributor to a private foundation (secs. 509(d)(2)(B) and (C)) apply.

Under the provision, a person is a related person ("related person") if a person is a member of the family (determined under section 4958(f)(4)) of a substantial contributor, or a 35 percent controlled entity, defined as a corporation, partnership, trust, or estate in which a substantial contributor or family member thereof owns more than 35 percent of the total combined voting power, profits interest, or beneficial interest, as the case may be.

In addition, under the provision, loans by any supporting organization (Type I, Type II, or Type III) to a disqualified person (as defined in section 4958) of the supporting organization are treated as an excess benefit transaction under section 4958 and the entire amount of the loan is treated as an excess benefit. For this purpose, a disqualified person does not include a public charity (other than a supporting organization).

*Disclosure requirements*

Under the provision, all supporting organizations are required to file an annual information return (Form 990 series) with the Secretary, regardless of the organization's gross receipts. A supporting organization must indicate on such annual information return whether it is a Type I, Type II, or Type III supporting organization and must identify its supported organizations.

Under the provision, supporting organizations must demonstrate annually that the organization is not controlled directly or indirectly by one or more disqualified persons (other than foundation managers and other than one or more publicly supported organizations) through a certification on the annual information return. It is intended that supporting organizations be able to certify that the majority of the organization's governing body is comprised of individuals who were selected based on their special knowledge or expertise in the particular field or discipline in which the supporting organization is operating, or because they represent the particular community that is served by the supported public charities.

*Disqualified person*

Under the provision, for purposes of the excess benefit transaction rules (sec. 4958), a disqualified person of a supporting organization is treated as a disqualified person of the supported organization.

***Provisions that apply to Type III supporting organizations***

*Payout with respect to Type III supporting organizations*

Under the provision, the Secretary shall promulgate new regulations on payments required by Type III supporting organizations that are not functionally integrated Type III supporting organizations.[993] Such regulations shall require such organizations to make distributions of a percentage either of income or assets to the public charities they support in order to ensure that a significant amount is paid to such supported organizations. A functionally integrated Type III supporting organization is a Type III supporting organization that is not required under regulations established by the Secretary to make payments to supported organizations due to the activities of the organization related to performing the functions of, or carrying out the purposes of, such supported organizations.[994]

*Excess business holdings*

Under the provision, the excess business holdings rules of section 4943 are applied to Type III supporting organizations (other than functionally integrated Type III supporting organizations). In applying such rules, the term disqualified person has the meaning provided in section 4958, and also includes substantial contributors and related persons and any organization that is effectively controlled by the same person or persons who control the supporting organization or any organization substantially all of the contributions to which were made by the same person or persons who made substantially all of the contributions to the supporting organization. The excess business holdings rules do not apply if, as of November 18, 2005, the holdings were held (and at all times thereafter, are held) for the benefit of the community pursuant to the direction (made as of such date) of a State attorney general or a

[993] See Treas. Reg. sec. 1.509(a)-4(i)(3)(iii).

[994] The current such regulation is Treasury regulation section 1.509(a)–4(i)(3)(ii). Under Treasury regulation section 1.509(a)–4(i)(3), the integral part test of current law may be satisfied in one of two ways, one of which requires a payout of substantially all of an organization's income to or for the use of one or more publicly supported organizations, and one of which does not require such a payout. There is concern that the current income-based payout does not result in a significant amount being paid to charity if assets held by a supporting organization produce little to no income, especially in relation to the value of the assets held by the organization, and as compared to amounts paid out by nonoperating private foundations. There also is concern that the current regulatory standards for satisfying the integral part test not by reason of a payout are not sufficiently stringent to ensure that there is a sufficient nexus between the supporting and supported organizations. In revising the regulations, the Secretary has the discretion to determine whether it is appropriate to impose a payout requirement on any or all organizations not currently required to payout. It is intended that, in revisiting the current regulations, if the distinction between Type III supporting organizations that are required to pay out and those that are not required to pay out is retained, which may be appropriate, the Secretary nonetheless shall strengthen the standard for qualification as an organization that is not required to pay out. For example, as one requirement, the Secretary may consider whether substantially all of the activities of such an organization should be activities in direct furtherance of the functions or purposes of supported organizations.

State official with jurisdiction over the Type III supporting organization.

The Secretary has the authority not to impose the excess business holdings rules if the organization establishes to the satisfaction of the Secretary that excess holdings of an organization are consistent with the purpose or function constituting the basis of the organization's exempt status. In exercising this authority, the Secretary should consider, in addition to any other factors the Secretary considers significant, as favorable, but not determinative, factors, a reasoned determination by the State attorney general with jurisdiction over the supporting organization, that disposition of the holdings would have a severe detrimental impact on the community, and a binding commitment by the supporting organization to pay out at least five percent of the value of the organization's assets each year to its supported organizations. A reasoned determination would require, among other things, evidence that any such determination was made pursuant to serious study by the State attorney general of the issues involved in disposing of the excess holdings, and findings by the State attorney general about the detrimental economic impact that would result from such disposition. If as a result of such State attorney general's study and findings, the State attorney general directed as a matter of State law that permission of the State would be required prior to any sale of the holdings, such a factor should be given strong consideration by the Secretary.

Transition rules apply to the present holdings of an organization similar to those of section 4943(c)(4)–(6).[995]

Under the provision, the excess business holdings rules also apply to Type II supporting organizations but only if such organization accepts any gift or contribution from a person (other than a public charity, not including a supporting organization) who (1) controls, directly or indirectly, either alone or together (with persons described below) the governing body of a supported organization of the supporting organization;[996] (2) is a member of the family of such a person; or (3) is a 35 percent controlled entity.

*Organizational and operational requirements*

The provision provides that, in general, after the date of enactment, a Type III supporting organization may not support an orga-

[995] Under the transition rules, in general, where the existing holdings of a supporting organization and disqualified persons are in excess of 50 percent (of a voting stock interest, profits interest, or beneficial interest), and not 20 percent or 35 percent as under the general rule, but are not in excess of 75 percent, a 10-year period is available before the holdings must be reduced to 50 percent. If such holdings are more than 75 percent, the reduction to 50 percent need not occur for a 15-year period. The 15-year period is expanded to 20 years if the holdings are more than 95 percent. After the expiration of the 10, 15, or 20 year period, if disqualified persons have holdings in a business enterprise in excess of two percent of the enterprise, the supporting organization has 15 additional years to dispose of any of its own holdings that are above 25 percent of the holdings in the enterprise. If disqualified persons do not have such holdings, then the supporting organization has 15 additional years to dispose of any of its own holdings that are above 35 percent of the holdings in the enterprise.

[996] For purposes of the provision, it is intended that indirect control includes the ability to exercise effective control. For example, if a person made a gift to a supporting organization and a combination of such person, a person related to such person, and such person's personal attorney were members of the five-member board of a supported organization of the supporting organization, the organization would be treated as being indirectly controlled by such person. Board membership alone does not establish direct or indirect control.

nization that is not organized in the United States.[997] But, for Type III supporting organizations that support a foreign organization on the date of enactment, the provision provides that the general rule does not apply until the first day of the third taxable year of the organization beginning after the date of enactment.

*Relationship to supported organization(s)*

Under the provision, a Type III supporting organization must apprise each organization it supports of information regarding the supporting organization in order to help ensure the supporting organization's responsiveness. It is intended that such a showing could be satisfied, for example, through provision of documentation such as a copy of the supporting organization's governing documents, any changes made to the governing documents, the organization's annual information return filed with the Secretary (Form 990 series), any tax return (Form 990–T) filed with the Secretary, and an annual report (including a description of all of the support provided by the supporting organization, how such support was calculated, and a projection of the next year's support). It is intended that failure to make a sufficient showing is a factor in determining whether the responsiveness test of present law is met.

In general, under the provision, a Type III supporting organization that is organized as a trust must, in addition to present law requirements, establish to the satisfaction of the Secretary, that it has a close and continuous relationship with the supported organization such that the trust is responsive to the needs or demands of the supported organization. A transition rule for existing trusts provides that the provision is not effective until one year after the date of enactment but is effective on the date of enactment for other trusts.

***Other provisions***

Under the provision, if a Type I or Type III supporting organization accepts any gift or contribution from a person (other than a public charity, not including a supporting organization) who (1) controls, directly or indirectly, either alone or together (with persons described below) the governing body of a supported organization of the supporting organization; (2) is a member of the family of such a person; or (3) is a 35 percent controlled entity, then the supporting organization is treated as a private foundation for all purposes until such time as the organization can demonstrate to the satisfaction of the Secretary that it qualifies as a public charity other than as a supporting organization.

Under the provision, a nonoperating private foundation may not count as a qualifying distribution under section 4942 any amount paid to (1) a Type III supporting organization that is not a functionally integrated Type III supporting organization or (2) any other supporting organization if a disqualified person with respect to the foundation directly or indirectly controls the supporting or-

[997] U.S. charities established principally to provide financial and other assistance to a foreign charity, sometimes referred to as "friends of" organizations, may not be established as supporting organizations under the provision. Such organizations may continue to obtain public charity status, however, by virtue of demonstrating broad public support (as described in sections 509(a)(1) and 509(a)(2)).

ganization or a supported organization of such supporting organization. Any amount that does not count as a qualifying distribution under this rule is treated as a taxable expenditure under section 4945.

### *Effective Date*

The provision generally is effective on the date of enactment (August 17, 2006). The excess benefit transaction rules are effective for transactions occurring after July 25, 2006 (except that the rule relating to the definition of a disqualified person is effective for transactions occurring after the date of enactment). The excess business holdings requirements are effective for taxable years beginning after the date of enactment. The provision relating to distributions by nonoperating private foundations is effective for distributions and expenditures made after the date of enactment. The return requirements are effective for returns filed for taxable years ending after the date of enactment.

## TITLE XIII—OTHER PROVISIONS

### A. Exception From Local Furnishing Requirements for Certain Alaska Hydroelectric Projects (sec. 1303 of the Act)

#### *Present Law*

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. Interest on State or local government bonds issued to finance activities of private persons is taxable unless a specific exception applies ("private activity bonds").

The interest on private activity bonds is eligible for tax-exemption if such bonds are issued for certain purposes permitted by the Code ("qualified private activity bonds"). The definition of a qualified private activity bond includes bonds issued to finance certain private facilities for the "local furnishing" of electricity or gas. Generally, a facility provides local furnishing if the area served by the facility does not exceed (1) two contiguous counties or (2) a city and a contiguous county.

The Code generally limits the local furnishing exception to bonds for facilities (1) of persons who were engaged in the local furnishing of electric energy or gas on January 1, 1997 (or a successor in interest to such persons), and (2) that serve areas served by those persons on such date (the "service area limitation") (sec. 142(f)(3)). The Small Business Job Protection Act of 1996 (the "Act") provided an exception from these limitations for bonds issued to finance the acquisition of the Snettisham hydroelectric project from the Alaska Power Administration (Pub. L. No. 104–188, sec. 1804 (1996)).

#### *Explanation of Provision*

The provision provides an exception from the service area limitation under section 142(f)(3) for bonds issued prior to May 31, 2006, to finance the Lake Dorothy hydroelectric project to provide electricity to the City of Hoonah, Alaska. In addition, the furnishing of electric service to the City of Hoonah, Alaska is disregarded for purposes of applying the local furnishing restrictions to bonds issued before May 31, 2006, to finance either the Lake Dorothy hydroelectric project (as defined in the provision) or to finance the acquisition of the Snettisham hydroelectric project.

#### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

## B. Extend Certain Tax Rules for Qualified Tuition Programs (sec. 1304 of the Act and sec. 529 of the Code)

### *Present Law*

#### *Overview*

Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.[998] A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a "prepaid tuition program").[999] In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a "savings account program").[1000] Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary's higher education expenses.

For this purpose, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance.[1001] Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time.[1002]

#### *Income tax treatment*

A qualified tuition program, including a savings account or a prepaid tuition contract established thereunder, generally is exempt from income tax, although it is subject to the tax on unrelated business income.[1003] Contributions to a qualified tuition account (or with respect to a prepaid tuition contract) are not deductible to the contributor or includible in income of the designated beneficiary or account owner. Earnings accumulate tax-free until a distribution is made. If a distribution is made to pay qualified higher education

---

[998] The term "account" refers to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

[999] Sec. 529(b)(1)(A).

[1000] Sec. 529(b)(1)(A).

[1001] Sec. 529(e)(3)(A).

[1002] Sec. 529(e)(3)(B).

[1003] Sec. 529(a). An interest in a qualified tuition account is not treated as debt for purposes of the debt-financed property rules under section 514. Sec. 529(e)(4).

expenses, no portion of the distribution is subject to income tax.[1004] If a distribution is not used to pay qualified higher education expenses, the earnings portion of the distribution is subject to Federal income tax[1005] and a 10-percent additional tax (subject to exceptions for death, disability, or the receipt of a scholarship).[1006] A change in the designated beneficiary of an account or prepaid contract is not treated as a distribution for income tax purposes if the new designated beneficiary is a member of the family of the old beneficiary.[1007]

### *Gift and generation-skipping transfer (GST) tax treatment*

A contribution to a qualified tuition account (or with respect to a prepaid tuition contract) is treated as a completed gift of a present interest from the contributor to the designated beneficiary.[1008] Such contributions qualify for the per-donee annual gift tax exclusion ($12,000 for 2006), and, to the extent of such exclusions, also are exempt from the generation-skipping transfer (GST) tax. A contributor may contribute in a single year up to five times the per-donee annual gift tax exclusion amount to a qualified tuition account and, for gift tax and GST tax purposes, treat the contribution as having been made ratably over the five-year period beginning with the calendar year in which the contribution is made.[1009]

A distribution from a qualified tuition account or prepaid tuition contract generally is not subject to gift tax or GST tax.[1010] Those taxes may apply, however, to a change of designated beneficiary if the new designated beneficiary is in a generation below that of the old beneficiary or if the new beneficiary is not a member of the family of the old beneficiary.[1011]

### *Estate tax treatment*

Qualified tuition program account balances or prepaid tuition benefits generally are excluded from the gross estate of any individual.[1012] Amounts distributed on account of the death of the designated beneficiary, however, are includible in the designated beneficiary's gross estate.[1013] If the contributor elected the special five-year allocation rule for gift tax annual exclusion purposes, any amounts contributed that are allocable to the years within the five-

---

[1004] Sec. 529(c)(3)(B). Any benefit furnished to a designated beneficiary under a qualified tuition account is treated as a distribution to the beneficiary for these purposes. Sec. 529(c)(3)(B)(iv).

[1005] Sec. 529(c)(3)(A) and (B)(ii).

[1006] Sec. 529(c)(6).

[1007] Sec. 529(c)(3)(C)(ii). For this purpose, "member of the family" means, with respect to a designated beneficiary: (1) the spouse of such beneficiary; (2) an individual who bears a relationship to such beneficiary which is described in paragraphs (1) through (8) of section 152(a) (i.e., with respect to the beneficiary, a son, daughter, or a descendent of either; a stepson or stepdaughter; a sibling or stepsibling; a father, mother, or ancestor of either; a stepfather or stepmother; a son or daughter of a brother or sister; a brother or sister of a father or mother; and a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law), or the spouse of any such individual; and (3) the first cousin of such beneficiary. Sec. 529(e)(2).

[1008] Sec. 529(c)(2)(A).

[1009] Sec. 529(c)(2)(B).

[1010] Sec. 529(c)(5)(A).

[1011] Sec. 529(c)(5)(B).

[1012] Sec. 529(c)(4)(A).

[1013] Sec. 529(c)(4)(B).

year period remaining after the year of the contributor's death are includible in the contributor's gross estate.[1014]

### *Certain provisions expiring under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")*

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") made a number of changes to the rules regarding qualified tuition programs. However, in order to comply with reconciliation procedures under the Congressional Budget Act of 1974, EGTRRA includes a "sunset" provision, pursuant to which the provisions of the Act 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, the Code will be applied as thought EGTRRA had never been enacted.

The provisions of present-law section 529 scheduled to expire by reason of the EGTRRA sunset provision include: (1) the provision that makes qualified withdrawals from qualified tuition accounts exempt from income tax; (2) the repeal of a pre-EGTRRA requirement that there be more than a de minimis penalty imposed on amounts not used for educational purposes and the imposition of the 10-percent additional tax on distributions not used for qualified higher education purposes; (3) a provision permitting certain private educational institutions to establish prepaid tuition programs that qualify under section 529 if they receive a ruling or determination to that effect from the Internal Revenue Service, and if the assets are held in a trust created or organized for the exclusive benefit of designated beneficiaries; (4) certain provisions permitting rollovers from one account to another account; (5) certain rules regarding the treatment of room and board as qualifying expenses; (6) certain rules regarding coordination with Hope and lifetime learning credit provisions; (7) the provision that treats first cousins as members of the family for purposes of the rollover and change in beneficiary rules; and (8) certain provisions regarding the education expenses of special needs beneficiaries.[1015]

## *Explanation of Provision*

### *Permanently extend EGTRRA modifications to qualified tuition program rules*

The provision repeals the sunset provision of EGTRRA insofar as it applies to the EGTRRA modifications to the rules regarding qualified tuition programs. As a result, the provision permanently extends all provisions of EGTRRA that expire at the end of 2010 that relate to qualified tuition programs.

### *Grant of regulatory authority to Treasury*

Present law regarding the transfer tax treatment of qualified tuition program accounts is unclear and in some situations imposes tax in a manner inconsistent with generally applicable transfer tax

[1014] Sec. 529(c)(4)(C).
[1015] EGTRRA sec. 402.

provisions. In addition, present law creates opportunities for abuse of qualified tuition programs. For example, taxpayers may seek to avoid gift and generation skipping transfer taxes by establishing and contributing to multiple qualified tuition program accounts with different designated beneficiaries (using the provision of section 529 that permits a contributor to contribute up to five times the annual exclusion amount per donee in a single year and treat the contribution as having been made ratably over five years), with the intention of subsequently changing the designated beneficiaries of such accounts to a single, common beneficiary and distributing the entire amount to such beneficiary without further transfer tax consequences. Taxpayers also may seek to use qualified tuition program accounts as retirement accounts with all of the tax benefits but none of the restrictions and requirements of qualified retirement accounts. The provision grants the Secretary broad regulatory authority to clarify the tax treatment of certain transfers and to ensure that qualified tuition program accounts are used for the intended purpose of saving for higher education expenses of the designated beneficiary, including the authority to impose related recordkeeping and reporting requirements. The provision also authorizes the Secretary to limit the persons who may be contributors to a qualified tuition program and to determine any special rules for the operation and Federal tax consequences of such programs if such contributors are not individuals.

### *Effective Date*

The provision is effective on the date of enactment (August 17, 2006).

# PART FOURTEEN: TAX RELIEF AND HEALTH CARE ACT OF 2006 (PUBLIC LAW 109–432) [1016]

## I. DIVISION A—EXTENSION AND EXPANSION OF CERTAIN TAX PROVISIONS AND OTHER PROVISIONS

## TITLE I—EXTENSION AND MODIFICATION OF CERTAIN PROVISIONS

### 1. Above-the-line deduction for higher education expenses (sec. 101 of the Act and sec. 222 of the Code)

#### *Present Law*

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

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

[1016] H.R. 6111. The House passed the bill on the suspension calendar on December 5, 2006. The Senate passed the bill with an amendment by unanimous consent on December 7, 2006. The House agreed to the Senate amendment with an amendment on December 8, 2006. The Senate agreed to the House amendment on December 8, 2006. The President signed the bill on December 20, 2006. For a technical explanation of the bill prepared by the staff of the Joint Committee on Taxation, see Joint Committee on Taxation, *Technical Explanation of H.R. 6408, the "Tax Relief and Health Care Act of 2006," as Introduced in the House on December 7, 2006* (JCX–50–06), December 7, 2006. For references to the technical explanation, see 152 Cong. Rec. H9069 (December 8, 2006) and 152 Cong. Rec. S11661 (December 8, 2006).

whom a Hope credit or Lifetime Learning credit is elected for such taxable year.

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

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

### *Explanation of Provision*

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

### *Effective Date*

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

## 2. Extension and modification of the new markets tax credit (sec. 102 of the Act and sec. 45D of the Code)

### *Present Law*

Section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity ("CDE").[1017] 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

[1017] Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, Pub. L. No. 106–554 (December 21, 2000).

proceeds of the investment cease to be used as required, or the equity investment is redeemed.

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE. A qualified equity investment means stock (other than nonqualified preferred stock as defined in sec. 351(g)(2)) in a corporation or a capital interest in a partnership that is acquired directly from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder. Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.

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

The Secretary has the authority to designate "targeted populations" as low-income communities for purposes of the new markets tax credit. For this purpose, a "targeted population" is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4702(20)) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who (A) are low-income persons; or (B) otherwise lack adequate access to loans or equity investments. Under such Act, "low-income" means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income or 80 percent of the statewide non-metropolitan area median family income.[1018] Under such Act, a targeted population is not required to be within any census tract. In addi-

[1018] 12 U.S.C. 4702(17) defines "low-income" for purposes of 12 U.S.C. 4702(20).

tion, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391, and is contiguous to one or more low-income communities.

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

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

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective on the date of enactment.

## 3. Deduction of state and local general sales taxes (sec. 103 of the Act and sec. 164 of the Code)

### *Present Law*

For purposes of determining regular tax liability, an itemized deduction is permitted for certain State and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. The itemized deduction is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. For taxable years beginning in 2004 and 2005, at the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction provided under present law for State and local income taxes. As is the case for State and local income taxes, the itemized deduction for State and local general sales taxes is not permitted for purposes of determining a taxpayer's alternative minimum taxable income. Taxpayers have two options with respect to the determination of the sales tax deduction amount. Taxpayers may deduct the total amount of general State and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers may use tables created by the Secretary of the Treasury that show the allowable deduction. The tables are based on average consumption by taxpayers on a State-by-State basis taking into account

number of dependents, modified adjusted gross income and rates of State and local general sales taxation. Taxpayers who live in more than one jurisdiction during the tax year are required to pro-rate the table amounts based on the time they live in each jurisdiction. Taxpayers who use the tables created by the Secretary may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats and other items specified by the Secretary. Sales taxes for items that may be added to the tables are not reflected in the tables themselves.

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

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

### *Explanation of Provision*

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

### *Effective Date*

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

## 4. Extension and modification of the research credit (sec. 104 of the Act and sec. 41 of the Code)

### *Present Law*

#### *General rule*

Prior to January 1, 2006, a taxpayer could claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceeded its base amount for that year.[1019] Thus, the research credit was generally available with respect to incremental increases in qualified research.

[1019] Sec. 41.

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

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

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

### *Computation of allowable credit*

Except for energy research payments and certain university basic research payments made by corporations, the research tax credit applied only to the extent that the taxpayer's qualified research expenses for the current taxable year exceeded its base amount. The base amount for the current year generally was computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage was the ratio that its total qualified research expenses for the 1984–1988 period bore to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). All other taxpayers (so-called start-up firms) were assigned a fixed-base percentage of three percent.[1020]

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

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, a special aggregation rule provided that all members of the same controlled group of corporations were treated as a single taxpayer (sec. 41(f)(1)). Under regulations prescribed by the Secretary, special rules applied for computing the credit when a major portion of a trade or business (or unit thereof) changed hands,

[1020] The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) was designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm would be assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. In the event that the research credit is extended beyond its expiration date, a start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage will be its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

under which qualified research expenses and gross receipts for periods prior to the change of ownership of a trade or business were treated as transferred with the trade or business that gave rise to those expenses and receipts for purposes of recomputing a taxpayer's fixed-base percentage (sec. 41(f)(3)).

### *Alternative incremental research credit regime*

Taxpayers were allowed to elect an alternative incremental research credit regime.[1021] If a taxpayer elected to be subject to this alternative regime, the taxpayer was assigned a three-tiered fixed-base percentage (that was lower than the fixed-base percentage otherwise applicable) and the credit rate likewise was reduced. Under the alternative incremental credit regime, a credit rate of 2.65 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equaled one percent of the taxpayer's average gross receipts for the four preceding years) but did not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of 1.5 percent but did not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of two percent. An election to be subject to this alternative incremental credit regime could be made for any taxable year beginning after June 30, 1996, and such an election applied to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury.

### *Eligible expenses*

Qualified research expenses eligible for the research tax credit consisted of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[1022] Notwithstanding the limitation for contract research expenses, qualified research expenses included 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

To be eligible for the credit, the research did not only have to satisfy the requirements of present-law section 174 (described below) but also had to be undertaken for the purpose of discovering information that is technological in nature, the application of which

[1021] Sec. 41(c)(4).

[1022] Under a special rule, 75 percent of amounts paid to a research consortium for qualified research were treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium was a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and was organized and operated primarily to conduct scientific research, and (2) such qualified research was conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

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

***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.[1023] While the research credit was in effect, however, deductions allowed to a taxpayer under section 174 (or any other section) were reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year (sec. 280C(c)). Taxpayers could alternatively elect to claim a reduced research tax credit amount (13 percent) under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

## *Explanation of Provision*

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

The provision also modifies the research credit for taxable years ending after December 31, 2006, subject to the general termination provision applicable to the credit.

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

[1023] Taxpayers may elect 10-year amortization of certain research expenditures allowable as a deduction under section 174(a). Secs. 174(f)(2) and 59(e).

amount computed by using a fixed-base percentage of two percent; and (3) a credit rate of five percent (rather than 3.75 percent) applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of two percent.

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

An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary. An election to use the alternative simplified credit may not be made for any taxable year for which an election to use the alternative incremental credit is in effect. A transition rule applies which permits a taxpayer to elect to use the alternative simplified credit in lieu of the alternative incremental credit if such election is made during the taxable year which includes January 1, 2007. The transition rule only applies to the taxable year which includes that date.

### *Effective Date*

The extension of the research credit applies to amounts paid or incurred after December 31, 2005. The modification of the alternative incremental credit and the addition of the alternative simplified credit are effective for taxable years ending after December 31, 2006.

Special transitional rules apply to fiscal year 2006–2007 taxpayers. In the case of a taxpayer electing the alternative incremental credit, the amount of the credit is the sum of (1) the credit calculated as if it were extended but not modified multiplied by a fraction the numerator of which is the number of days in the taxable year before January 1, 2007, and the denominator of which is the total number of days in the taxable year and (2) the credit calculated under the provision as amended multiplied by a fraction the numerator of which is the number of days in the taxable year after December 31, 2006, and the denominator of which is the total number of days in the taxable year.

In the case of a taxpayer electing the new alternative simplified credit, the amount of the credit under section 41(a)(1) for the taxable year is the sum of (1) the credit that would be determined under section 41(a)(1) (including the alternative incremental credit for a taxpayer electing that credit) if it were extended but not modified multiplied by a fraction the numerator of which is the number of days in the taxable year before January 1, 2007, and the denominator of which is the total number of days in the taxable year and (2) the alternative simplified credit determined for the year multiplied by a fraction the numerator of which is the number of days in the taxable year after December 31, 2006, and the denominator of which is the total number of days in the taxable year.

## 5. Work opportunity tax credit and welfare-to-work tax credit (sec. 105 of the Act and secs. 51 and 51A of the Code)

### *Present Law*

#### *Work opportunity tax credit*

*Targeted groups eligible for the credit*

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

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

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

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

*Qualified wages*

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

*Calculation of the credit*

The credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of $6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages).

*Certification rules*

An individual is not treated as a member of a targeted group unless: (1) on or before the day on which an individual begins work for an employer, the employer has received a certification from a

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

*Minimum employment period*

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

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

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

*Other rules*

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

*Expiration*

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

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

*Targeted group eligible for the credit*

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

*Qualified wages*

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

*Calculation of the credit*

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

*Certification rules*

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

*Minimum employment period*

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

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

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

*Other rules*

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

*Expiration*

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

## *Explanation of Provision*

### *First year of extension*

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

### *Second year of extension*

*In general*

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

*Targeted groups eligible for the combined credit*

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

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

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

*Qualified wages*

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

*Calculation of the credit*

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

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

*Certification rules*

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

*Minimum employment period*

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

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

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

### *Effective Date*

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

## 6. Extend election to treat combat pay as earned income for purposes of the earned income credit (sec. 106 of the Act and sec. 32 of the Code)

### *Present Law*

#### *In general*

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

### *Child credit*

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

### *Earned income credit*

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

### *Explanation of Provision*

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

### *Effective Date*

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

## 7. Extension and modification of qualified zone academy bonds (sec. 107 of the Act and sec. 1397E of the Code)

### *Present Law*

### *Tax-exempt bonds*

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

An issuer must file with the IRS certain information in order for a bond issue to be tax-exempt.[1024] Generally, this information return is required to be filed no later the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

### *Qualified zone academy bonds*

As an alternative to traditional tax-exempt bonds, the Code permits three types of tax-credit bonds. States and local governments have the authority to issue qualified zone academy bonds ("QZABS"), clean renewable energy bonds ("CREBS"), and "Gulf tax credit bonds."[1025] In lieu of tax-exempt interest, these bonds entitle eligible holders to a tax credit.

QZABs are defined as any bond issued by a State or local government if, among other requirements: (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equip-

[1024] Sec. 149(e).
[1025] Secs. 1397E, 54, and 1400N(l), respectively.

ment 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.

A total of $400 million of QZABs 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 issuance authority to qualified zone academies within such State.

Financial institutions (banks, insurance companies, and corporations in the business of lending money) are the only taxpayers eligible to hold QZABs. An eligible taxpayer holding a QZAB on the credit allowance date is entitled to a credit. The credit is an amount equal to a credit rate multiplied by the face amount of the bond. 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 on QZABs at a rate estimated to allow issuance of the 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.

Issuers of QZABs 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 income exclusion for interest paid on States and local bonds does not apply to any arbitrage bond.[1026] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.[1027] In general, arbitrage profits may be earned only during specified periods

[1026] Sec. 103(b)(2).
[1027] Sec. 148.

(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. Under present law, the arbitrage rules apply to CREBs and Gulf tax credit bonds, but do not apply to QZABs.

### *Explanation of Provision*

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

In addition, the provision imposes the arbitrage requirements of section 148 that apply to interest-bearing tax-exempt bonds to QZABs. Principles under section 148 and the regulations thereunder shall apply for purposes of determining the yield restriction and arbitrage rebate requirements applicable to QZABs. For example, for arbitrage purposes, the yield on an issue of QZABs 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 QZABs is not treated as interest, although such credit amount is treated as interest income to the taxpayer.

The provision also imposes new spending requirements for QZABs. An issuer of QZABs 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 QZABs 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. The provision provides that the five-year spending period may be extended by the Secretary if the issuer establishes that the failure to meet the spending requirement is due to reasonable cause and the related purposes for issuing the bonds will continue to proceed with due diligence.

Finally, issuers of QZABs are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds.

### *Effective Date*

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

### 8. Above-the-line deduction for certain expenses of elementary and secondary school teachers (sec. 108 of the Act and sec. 62 of the Code)

#### *Present Law*

In general, ordinary and necessary business expenses are deductible (sec. 162). However, in general, unreimbursed employee business expenses are deductible only as an itemized deduction and only to the extent that the individual's total miscellaneous deductions (including employee business expenses) exceed two percent of adjusted gross income. An individual's otherwise allowable itemized deductions may be further limited by the overall limitation on itemized deductions, which reduces itemized deductions for taxpayers with adjusted gross income in excess of $150,500 (for 2006).[1028] In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed as an above-the-line deduction. Specifically, for taxable years beginning after December 31, 2001, and prior to January 1, 2006, an above-the-line deduction is allowed for up to $250 annually of expenses paid or incurred by an eligible educator for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under 162 as a trade or business expense. A deduction is allowed only to the extent the amount of expenses exceeds the amount excludable from income under section 135 (relating to education savings bonds), 529(c)(1) (relating to qualified tuition programs), and section 530(d)(2) (relating to Coverdell education savings accounts).

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

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

#### *Explanation of Provision*

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

#### *Effective Date*

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

---

[1028] The adjusted income threshold is $75,250 in the case of a married individual filing a separate return (for 2006). For 2007, the adjusted income threshold is $156,400 ($78,200 for a married individual filing a separate return).

### 9. Extension and expansion to petroleum products of expensing for environmental remediation costs (sec. 109 of the Act and sec. 198 of the Code)

#### *Present Law*

Present law allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.[1029] Treasury regulations provide that the cost of incidental repairs that neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense. Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury regulations define "capital expenditures" as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use. Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

Taxpayers may elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred.[1030] 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.*[1031] 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")[1032] cannot qualify as targeted areas. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use. Petroleum products generally are not regarded as hazardous substances for

[1029] Sec. 162.
[1030] Sec. 198.
[1031] 418 U.S. 1 (1974).
[1032] Pub. L. No. 96–510 (1980).

purposes of section 198 (except for purposes of determining qualified environmental remediation expenditures in the "Gulf Opportunity Zone" under section 1400N(g), as described below).[1033]

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

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

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

### *Explanation of Provision*

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

In addition, the provision expands the definition of hazardous substance to include petroleum products. Under the provision, petroleum products are defined by reference to section 4612(a)(3), and thus include crude oil, crude oil condensates and natural gasoline.[1034]

### *Effective Date*

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

---

[1033] 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."

[1034] The present law exceptions for sites on the national priorities list under CERCLA, and for substances with respect to which a removal or remediation is not permitted under section 104 of CERCLA by reason of subsection (a)(3) thereof, would continue to apply to all hazardous substances (including petroleum products).

## 10. Tax incentives for investment in the District of Columbia (sec. 110 of the Act and secs. 1400, 1400A, 1400B, and 1400C of the Code)

### *Present Law*

#### *In general*

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

#### *Wage credit*

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

Wages paid to a qualified employee who earns more than $15,000 are eligible for the wage credit (although only the first $15,000 of wages is eligible for the credit). The wage credit is available with respect to a qualified full-time or part-time employee (employed for at least 90 days), regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the D.C. Zone may claim the wage credit, regardless of whether the employer meets the definition of a "D.C. Zone business."[1035]

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.[1036] 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.[1037] In addition, the $15,000 cap is re-

[1035] 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 eleigible 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.

[1036] Sec. 280C(a).

[1037] Secs. 1400H(a), 1396(c)(3)(A) and 51A(d)(2).

duced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.[1038] The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.[1039]

***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.[1040] The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified zone property placed in service during the year by the taxpayer exceeds $200,000 ($400,000 for taxable years beginning after 2002 and before 2010). The term "qualified zone property" is defined as depreciable tangible property (including buildings), provided that (1) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (2) the original use of the property in the D.C. Zone commences with the taxpayer, and (3) substantially all of the use of the property is in the D.C. Zone in the active conduct of a trade or business by the taxpayer.[1041] 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.[1042] 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.[1043] 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, quali-

[1038] Secs. 1400H(a), 1396(c)(3)(B) and 51A(d)(2).
[1039] Sec. 38(c)(2).
[1040] Sec. 1397A.
[1041] Sec. 1397D.
[1042] Sec. 1400A.
[1043] Sec. 1400B.

fies for the zero-percent rate, provided that such real property or intangible asset is an integral part of a qualified D.C. Zone business.[1044] However, no gain attributable to periods before January 1, 1998, and after December 31, 2010, is qualified capital gain.

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

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price. The $5,000 maximum credit applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of $2,500 each. The credit phases out for individual taxpayers with adjusted gross income between $70,000 and $90,000 ($110,000–$130,000 for joint filers). For purposes of eligibility, "first-time homebuyer" means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one-year period ending on the date of the purchase of the residence to which the credit applies. The credit expired for purchases after December 31, 2005.[1045]

### *Explanation of Provision*

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

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

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

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

### *Effective Date*

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

## 11. Indian employment tax credit (sec. 111 of the Act and sec. 45A of the Code)

### *Present Law*

In general, a credit against income tax liability is allowed to employers for the first $20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the employer with respect to certain employees (sec. 45A). The credit is equal to 20 percent of the excess of eligible employee qualified wages and health insurance costs during the current year over the amount of such wages and costs incurred by the employer during 1993. The

[1044] 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).

[1045] Sec. 1400C(i).

credit is an incremental credit, such that an employer's current-year qualified wages and qualified employee health insurance costs (up to $20,000 per employee) are eligible for the credit only to the extent that the sum of such costs exceeds the sum of comparable costs paid during 1993. No deduction is allowed for the portion of the wages equal to the amount of the credit.

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

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

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

### *Explanation of Provision*

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

### *Effective Date*

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

## 12. Accelerated depreciation for business property on Indian reservations (sec. 112 of the Act and sec. 168 of the Code)

### *Present Law*

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

| *Property* | *Years* |
|---|---|
| 3-year | 2 |
| 5-year | 3 |
| 7-year | 4 |
| 10-year | 6 |
| 15-year | 9 |
| 20-year | 12 |
| Nonresidential real | 22 |

"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 CFR 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 reservation property is available with respect to property placed in service on or after January 1, 1994, and before January 1, 2006.

### *Explanation of Provision*

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

### *Effective Date*

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

## 13. Fifteen-year straight-line cost recovery for qualified leasehold improvements and qualified restaurant property (sec. 113 of the Act and sec. 168 of the Code)

### *Present Law*

#### *In general*

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

#### *Depreciation of leasehold improvements*

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

#### *Qualified leasehold improvement property*

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

cupied 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 nonrecognition treatment.

***Qualified restaurant property***

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

### *Explanation of Provision*

The present-law provisions are extended for two years (through December 31, 2007).

### *Effective Date*

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

## 14. Suspend limitation on rate of rum excise tax cover over to Puerto Rico and Virgin Islands (sec. 114 of the Act and sec. 7652 of the Code)

### *Present Law*

A $13.50 per proof gallon[1046] excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States.[1047] 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).[1048]

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

[1046] A proof gallon is a liquid gallon consisting of 50 percent alcohol. See sec. 5002(a)(10) and (11).

[1047] Sec. 5001(a)(1).

[1048] Secs. 5062(b), 7653(b) and (c).

origin.[1049] The amount of the cover over is limited under Code section 7652(f) to $10.50 per proof gallon ($13.25 per proof gallon during the period July 1, 1999 through December 31, 2005).

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.[1050] 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.[1051] All of the amounts covered over are subject to the limitation.

### *Explanation of Provision*

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

### *Effective Date*

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

## 15. Parity in the application of certain limits to mental health benefits (sec. 115 of the Act and sec. 9812(f)(3) of the Code, sec. 712(f) of ERISA, and sec. 2705(f) of the PHSA)

### *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.

---

[1049] 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).

[1050] Sec. 7652(e)(2).

[1051] Secs. 7652(a)(3), (b)(3), and (e)(1).

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

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

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

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective on the date of enactment.

## 16. Expand charitable contribution allowed for scientific property used for research and expand and extend the charitable contribution allowed computer technology and equipment (sec. 116 of the Act and sec. 170 of the Code)

### *Present Law*

In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the charitable deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property.[1052]

Under present law, a taxpayer's deduction for charitable contributions of scientific property used for research and for contributions of computer technology and equipment generally is limited to the taxpayer's basis (typically, cost) in the property. However, certain corporations may claim a deduction in excess of basis for a

[1052] Sec. 170(e)(1).

"qualified research contribution" or a "qualified computer contribution."[1053] This enhanced deduction is equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. The enhanced deduction for qualified computer contributions expired for any contribution made during any taxable year beginning after December 31, 2005.

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

A qualified computer contribution means a charitable contribution of any computer technology or equipment, which meets standards of functionality and suitability as established by the Secretary of the Treasury. The contribution must be to certain educational organizations or public libraries and made not later than three years after the taxpayer acquired the property or, if the taxpayer constructed the property, not later than the date construction of the property is substantially completed.[1054] The original use of the property must be by the donor or the donee, and in the case of the donee,[1055] must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed by the taxpayer, the rules applicable to qualified research contributions apply. Contributions may be made to private foundations under certain conditions.[1056]

### *Explanation of Provision*

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

---

[1053] Secs. 170(e)(4) and 170(e)(6).

[1054] If the taxpayer constructed the property and reacquired such property, the contribution must be within three years of the date the original construction was substantially completed. Sec. 170(e)(6)(D)(i).

[1055] This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

[1056] Sec. 170(e)(6)(C).

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

### *Effective Date*

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

## 17. Availability of Archer medical savings accounts (sec. 117 of the Act and sec. 220 of the Code)

### *Present Law*

#### *Archer medical savings accounts*

*In general*

Within limits, contributions to an Archer medical savings account ("Archer MSA") are deductible in determining adjusted gross income if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an Archer MSA are not currently taxable. Distributions from an Archer MSA for medical expenses are not includible in gross income. Distributions not used for medical expenses are includible in gross income. In addition, distributions not used for medical expenses are subject to an additional 15-percent tax unless the distribution is made after age 65, death, or disability.

*Eligible individuals*

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

*Tax treatment of and limits on contributions*

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

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

*Definition of high deductible plan*

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

*Cap on taxpayers utilizing Archer MSAs and expiration of pilot program*

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

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

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

### *Health savings accounts*

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

## *Explanation of Provision*

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

The report required by Archer MSA trustees to be made on August 1, 2005, or August 1, 2006, (as the case may be) is treated as timely filed if made before the close of the 90-day period beginning on the date of enactment. The determination and publication with respect to calendar year 2005 or 2006 whether the threshold level has been exceeded is treated as timely if made before the close of the 120-day period beginning on the date of enactment. If it is determined that 2005 or 2006 is a cut-off year, the cut-off date is the last date of such 120-day period.

### *Effective Date*

The provision is effective on the date of enactment.

## 18. Taxable income limit on percentage depletion for oil and natural gas produced from marginal properties (sec. 118 of the Act and sec. 613A of the Code)

### *Present Law*

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

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

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

### *Explanation of Provision*

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

### *Effective Date*

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

## 19. Economic development credit for American Samoa (sec. 119 of the Act)

### *Present Law*

#### *In general*

Certain domestic corporations with business operations in the U.S. possessions are eligible for the possession tax credit.[1057] This credit offsets the U.S. tax imposed on certain income related to operations in the U.S. possessions.[1058] For purposes of the credit, possessions include, among other places, American Samoa. Subject to certain limitations described below, the amount of the possession tax credit allowed to any domestic corporation equals the portion of that corporation's U.S. tax that is attributable to the corporation's non-U.S. source taxable income from (1) the active conduct of a trade or business within a U.S. possession, (2) the sale or exchange of substantially all of the assets that were used in such a trade or business, or (3) certain possessions investment.[1059] No deduction or foreign tax credit is allowed for any possessions or foreign tax paid or accrued with respect to taxable income that is taken into account in computing the credit under section 936.[1060] The section 936 credit expires for taxable years beginning after December 31, 2005.

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

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

#### *Qualification as existing credit claimant*

A corporation is an existing credit claimant with respect to a possession if (1) the corporation was engaged in the active conduct of a trade or business within the possession on October 13, 1995, and (2) the corporation elected the benefits of the possession tax credit in an election in effect for its taxable year that included October 13, 1995.[1061] A corporation that adds a substantial new line of

---

[1057] Secs. 27(b), 936.

[1058] Domestic corporations with activities in Puerto Rico are eligible for the section 30A economic activity credit. That credit is calculated under the rules set forth in section 936.

[1059] Under phase-out rules described below, investment only in Guam, American Samoa, and the Northern Mariana Islands (and not in other possessions) now may give rise to income eligible for the section 936 credit.

[1060] Sec. 936(c).

[1061] A corporation will qualify as an existing credit claimant if it acquired all the assets of a trade or business of a corporation that (1) actively conducted that trade or business in a pos-

business (other than in a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) ceases to be an existing credit claimant as of the close of the taxable year ending before the date on which that new line of business is added.

***Economic activity-based limit***

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

***Income-based limit***

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

***Repeal and phase out***

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

## *Explanation of Provision*

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

The amount of the credit allowed to a qualifying domestic corporation under the provision is equal to the sum of the amounts used in computing the corporation's economic activity-based limitation (described above in the present law section) with respect to American Samoa, except that no credit is allowed for the amount of any American Samoa income taxes. Thus, for any qualifying corporation the amount of the credit equals the sum of (1) 60 percent

---

session on October 13, 1995, and (2) had elected the benefits of the possession tax credit in an election in effect for the taxable year that included October 13, 1995.

of the corporation's qualified American Samoa wages and allocable employee fringe benefit expenses and (2) 15 percent of the corporation's depreciation allowances with respect to short-life qualified American Samoa tangible property, plus 40 percent of the corporation's depreciation allowances with respect to medium-life qualified American Samoa tangible property, plus 65 percent of the corporation's depreciation allowances with respect to long-life qualified American Samoa tangible property.

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

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

### *Effective Date*

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

## 20. Extension of placed-in-service deadline for certain Gulf Opportunity Zone property (sec. 120 of the Act and sec. 1400N of the Code)

### *Present Law*

#### *In general*

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

#### *Gulf Opportunity Zone property*

Present law provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified Gulf Opportunity Zone [1062] property. In order to qualify, property generally

[1062] 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

must be placed in service on or before December 31, 2007 (December 31, 2008 in the case of nonresidential real property and residential rental property).

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

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

---

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

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

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

### *Explanation of Provision*

The provision extends the placed-in-service deadline for specified Gulf Opportunity Zone extension property to qualify for the additional first-year depreciation deduction.[1063] Specified Gulf Opportunity Zone extension property is defined as property substantially all the use of which is in one or more specified portions of the Gulf Opportunity Zone and which is either: (1) nonresidential real property or residential rental property which is placed in service by the taxpayer on or before December 31, 2010, or (2) in the case of a taxpayer who places in service a building described in (1), property described in section 168(k)(2)(A)(i)[1064] if substantially all the use of such property is in such building and such property is placed in service within 90 days of the date the building is placed in service. However, in the case of nonresidential real property or residential rental property, only the adjusted basis of such property attributable to manufacture, construction, or production before January 1, 2010 ("progress expenditures") is eligible for the additional first-year depreciation.

The specified portions of the Gulf Opportunity Zone are defined as those portions of the Gulf Opportunity Zone which are in a county or parish which is identified by the Secretary of the Treasury (or his delegate) as being a county or parish in which hurricanes occurring in 2005 damaged (in the aggregate) more than 60 percent of the housing units in such county or parish which were occupied (determined according to the 2000 Census.)[1065]

---

[1063] The extension of the placed-in-service deadline does not apply for purposes of the increased section 179 expensing limit available to Gulf Opportunity Zone property.

[1064] Generally, property described in section 168(k)(2)(A)(i) is (1) property to which the general rules of the Modified Accelerated Cost Recovery System ("MACRS") apply with an applicable recovery period of 20 years or less, (2) computer software other than computer software covered by section 197, (3) water utility property (as defined in section 168(e)(5)), or (4) certain leasehold improvement property.

[1065] The Office of the Federal Coordinator for Gulf Coast Rebuilding at the Department of Homeland Security, in cooperation with the Federal Emergency Management Agency, the Small Business Administration, and the Department of Housing and Urban Development, compiled data to assess the full extent of housing damage due to 2005 Hurricanes Katrina, Rita, and Wilma. The data was published on February 12, 2006 and is available at *www.dhs.gov/xlibrary/assets/GulfCoast*__HousingDamageEstimates__021206.pdf (last accessed December 5,

### *Effective Date*

The provision applies as if included in section 101 of the Gulf Opportunity Zone Act of 2005[1066] ("GOZA"). Section 101 of GOZA is effective for property placed in service on or after August 28, 2005, in taxable years ending on or after such date.

## 21. Authority for undercover operations (sec. 121 of the Act and sec. 7608 of the Code)

### *Present Law*

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

The provision was originally enacted in The Anti-Drug Abuse Act of 1988. The exemption originally expired on December 31, 1989, and was extended by the Comprehensive Crime Control Act of 1990 to December 31, 1991. There followed a gap of approximately four and a half years during which the provision had lapsed. In the Taxpayer Bill of Rights II, the authority to use proceeds from undercover operations was extended for five years, through 2000. The Community Renewal Tax Relief Act of 2000 extended the authority of the IRS to use proceeds from undercover operations for an additional five years, through 2005. The Gulf Opportunity Zone Act of 2005 extended the authority through December 31, 2006.

### *Explanation of Provision*

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

### *Effective Date*

The provision is effective on the date of enactment.

---

2006). It is intended that the Secretary or his delegate will make use of this data in identifying counties and parishes which qualify under the provision.

[1066] Pub. L. No. 109–135 (2005).

## 22. Disclosures of certain tax return information (sec. 122 of the Act and sec. 6103 of the Code)

### (a) Disclosure of tax information to facilitate combined employment tax reporting

#### *Present Law*

Traditionally, Federal tax forms are filed with the Federal government and State tax forms are filed with individual States. This necessitates duplication of items common to both returns. The Code permits the IRS to disclose taxpayer identity information and signatures to any agency, body, or commission of any State for the purpose of carrying out with such agency, body or commission a combined Federal and State employment tax reporting program approved by the Secretary.[1067] The Federal disclosure restrictions, safeguard requirements, and criminal penalties for unauthorized disclosure and unauthorized inspection do not apply with respect to disclosures or inspections made pursuant to this authority. This provision expires after December 31, 2006.

Separately, under section 6103(c), the IRS may disclose a taxpayer's return or return information to such person or persons as the taxpayer may designate in a request for or consent to such disclosure. Pursuant to Treasury regulations, a taxpayer's participation in a combined return filing program between the IRS and a State agency, body or commission constitutes a consent to the disclosure by the IRS to the State agency of taxpayer identity information, signature and items of common data contained on the return.[1068] No disclosures may be made under this authority unless there are provisions of State law protecting the confidentiality of such items of common data.

#### *Explanation of Provision*

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

#### *Effective Date*

The provision applies to disclosures after December 31, 2006.

### (b) Disclosure of return information regarding terrorist activities

#### *Present Law*

***In general***

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

[1067] Sec. 6103(d)(5).
[1068] Treas. Reg. sec. 301.6103(c)–1(d)(2).

nontax criminal investigations) when certain conditions are satisfied.

Among the disclosures permitted under the Code is disclosure of returns and return information for purposes of investigating terrorist incidents, threats, or activities, and for analyzing intelligence concerning terrorist incidents, threats, or activities. The term "terrorist incident, threat, or activity" is statutorily defined to mean an incident, threat, or activity involving an act of domestic terrorism or international terrorism.[1069] In general, returns and taxpayer return information must be obtained pursuant to an ex parte court order. Return information, other than taxpayer return information, generally is available upon a written request meeting specific requirements. The IRS also is permitted to make limited disclosures of such information on its own initiative to the appropriate Federal law enforcement agency.

No disclosures may be made under these provisions after December 31, 2006. The procedures applicable to these provisions are described in detail below.

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

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

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

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

---

[1069] Sec. 6103(b)(11). For this purpose, "domestic terrorism" is defined in 18 U.S.C. sec. 2331(5) and "international terrorism" is defined in 18 U.S.C. sec. 2331.

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

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

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

*Disclosure by the IRS without a request*

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

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

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

dents, threats, or activities. The information is to be used by such officers and employees solely for such response or investigation.

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

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

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

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

### *Explanation of Provision*

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

### *Effective Date*

The provision applies to disclosures after December 31, 2006.

### (c) Disclosure of return information to carry out income contingent repayment of student loans

### *Present Law*

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

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

### *Explanation of Provision*

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

### *Effective Date*

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

## 23. Special rule for elections under expired provisions (sec. 123 of the Act)

### *Present Law*

Under present law, various elections under provisions of the Code must be made by a certain date and in a certain manner. For example, the election under section 280C(c)(3) of a reduced credit for increasing research expenditures must be made not later than the time for filing a return (including extensions).

### *Explanation of Provision*

The provision provides that, in the case of any taxable year which ends after December 31, 2005 and before the date of enactment of the Act, an election under section 41(c)(4), 280C(c)(3)(C), or any other expired provision of the Code which is extended by the Act, is treated as timely if made not later than April 15, 2007, or such other time as the Secretary or his designee provide. The election shall be made in the manner prescribed by the Secretary or his designee.

### *Effective Date*

The provision is effective on the date of enactment.

## TITLE II—ENERGY TAX PROVISIONS

### 1. Extension of placed-in-service date for tax credit for electricity produced at wind, closed-loop biomass, open-loop biomass, geothermal energy, small irrigation power, landfill gas, trash combustion, or qualified hydropower facilities (sec. 201 of the Act and sec. 45 of the Code)

#### *Present Law*

***In general***

An income tax credit is allowed for the production of electricity at qualified facilities using qualified energy resources (sec. 45). Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal, energy, solar energy, small irrigation power, municipal solid waste, and qualified hydropower production. Qualified facilities are, generally, facilities that generate electricity using qualified energy resources. To be eligible for the credit, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person. In addition to the electricity production credit, an income tax credit is allowed for the production of refined coal and Indian coal at qualified facilities.

***Credit amounts and credit period***

*In general*

The base amount of the credit is 1.5 cents per kilowatt-hour (indexed annually for inflation) of electricity produced. The amount of the credit is 1.9 cents per kilowatt-hour for 2006. A taxpayer may generally claim a credit during the 10-year period commencing with the date the qualified facility is placed in service. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits.

The amount of credit a taxpayer may claim is phased out as the market price of electricity (or refined coal in the case of the refined coal production credit) exceeds certain threshold levels. The electricity production credit is reduced over a 3 cent phase-out range to the extent the annual average contract price per kilowatt hour of electricity sold in the prior year from the same qualified energy resource exceeds 8 cents (adjusted for inflation). The refined coal credit is reduced over an $8.75 phase-out range as the reference price of the fuel used as feedstock for the refined coal exceeds the reference price for such fuel in 2002 (adjusted for inflation).

*Reduced credit amounts and credit periods*

Generally, in the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), geothermal energy facilities, solar energy facilities, small irrigation power facilities,

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

In the case of open-loop biomass facilities (including agricultural livestock waste nutrient facilities), small irrigation power facilities, landfill gas facilities, trash combustion facilities, and qualified hydropower facilities the otherwise allowable credit amount is 0.75 cent per kilowatt-hour, indexed for inflation measured after 1992 (currently 0.9 cents per kilowatt-hour for 2006).

*Credit applicable to refined coal*

The amount of the credit for refined coal is $4.375 per ton (also indexed for inflation after 1992 and equaling $5.679 per ton for 2006).

*Credit applicable to Indian coal*

A credit is available for the sale of Indian coal to an unrelated third part from a qualified facility for a seven-year period beginning on January 1, 2006, and before January 1, 2013. The amount of the credit for Indian coal is $1.50 per ton for the first four years of the seven-year period and $2.00 per ton for the last three years of the seven-year period. Beginning in calendar years after 2006, the credit amounts are indexed annually for inflation using 2005 as the base year.

*Other limitations on credit claimants and credit amounts*

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

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

The credit for electricity produced from renewable sources is a component of the general business credit (sec. 38(b)(8)). Generally, the general business credit for any taxable year may not exceed the amount by which the taxpayer's net income tax exceeds the greater of the tentative minimum tax or so much of the net regular tax liability as exceeds $25,000. Excess credits may be carried back one year and forward up to 20 years.

A taxpayer's tentative minimum tax is treated as being zero for purposes of determining the tax liability limitation with respect to the section 45 credit for electricity produced from a facility (placed in service after October 22, 2004) during the first four years of production beginning on the date the facility is placed in service.

***Qualified facilities***

*Wind energy facility*

A wind energy facility is a facility that uses wind to produce electricity. To be a qualified facility, a wind energy facility must be placed in service after December 31, 1993, and before January 1, 2008.

*Closed-loop biomass facility*

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

To be a qualified facility, a closed-loop biomass facility must be placed in service after December 31, 1992, and before January 1, 2008. In the case of a facility using closed-loop biomass but also co-firing the closed-loop biomass with coal, other biomass, or coal and other biomass, a qualified facility must be originally placed in service and modified to co-fire the closed-loop biomass at any time before January 1, 2008.

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

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

- forest-related resources, including mill and harvesting residues, precommercial thinnings, slash, and brush;
- solid wood waste materials, including waste pallets, crates, dunnage, manufacturing and construction wood wastes, landscape or right-of-way tree trimming; or

- agricultural sources, including orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues.

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

In the case of an open-loop biomass facility that uses agricultural livestock waste nutrients, a qualified facility is one that was originally placed in service after October 22, 2004, and before January 1, 2008, and has a nameplate capacity rating which is not less than 150 kilowatts. In the case of any other open-loop biomass facility, a qualified facility is one that was originally placed in service before January 1, 2008.

*Geothermal facility*

A geothermal facility is a facility that uses geothermal energy to produce electricity. Geothermal energy is energy derived from a geothermal deposit which is a geothermal reservoir consisting of natural heat which is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure). To be a qualified facility, a geothermal facility must be placed in service after October 22, 2004 and before January 1, 2008.

*Solar facility*

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

*Small irrigation facility*

A small irrigation power facility is a facility that generates electric power through an irrigation system canal or ditch without any dam or impoundment of water. The installed capacity of a qualified facility must be not less than 150 kilowatts but less than five megawatts. To be a qualified facility, a small irrigation facility must be originally placed in service after October 22, 2004 and before January 1, 2008.

*Landfill gas facility*

A landfill gas facility is a facility that uses landfill gas to produce electricity. Landfill gas is defined as methane gas derived from the biodegradation of municipal solid waste. To be a qualified facility, a landfill gas facility must be placed in service after October 22, 2004 and before January 1, 2008.

*Trash combustion facility*

Trash combustion facilities are facilities that burn municipal solid waste (garbage) to produce steam to drive a turbine for the

production of electricity. To be a qualified facility, a trash combustion facility must be placed in service after October 22, 2004 and before January 1, 2008. A qualified trash combustion facility includes a new unit, placed in service after October 22, 2004, that increases electricity production capacity at an existing trash combustion facility. A new unit generally would include a new burner/boiler and turbine. The new unit may share certain common equipment, such as trash handling equipment, with other pre-existing units at the same facility. Electricity produced at a new unit of an existing facility qualifies for the production credit only to the extent of the increased amount of electricity produced at the entire facility.

*Hydropower facility*

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

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

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

*Refined coal facility*

A qualifying refined coal facility is a facility producing refined coal that is placed in service after October 22, 2004 and before January 1, 2009. Refined coal is a qualifying liquid, gaseous, or solid synthetic fuel produced from coal (including lignite) or high-carbon fly ash, including such fuel used as a feedstock. A qualifying fuel is a fuel that when burned emits 20 percent less nitrogen oxides and either SO2 or mercury than the burning of feedstock coal or comparable coal predominantly available in the marketplace as of January 1, 2003, and if the fuel sells at prices at least 50 percent

greater than the prices of the feedstock coal or comparable coal. In addition, to be qualified refined coal the fuel must be sold by the taxpayer with the reasonable expectation that it will be used for the primary purpose of producing steam.

*Indian coal facility*

A qualified Indian coal facility is a facility which is placed in service before January 1, 2009, that produces coal from reserves that on June 14, 2005, were owned by a Federally recognized tribe of Indians or were held in trust by the United States for a tribe or its members.

### *Summary of credit rate and credit period by facility type*

**Table 10.—Summary of Section 45 Credit for Electricity Produced from Certain Renewable Resources, for Refined Coal, and for Indian Coal**

| Eligible electricity production or coal production activity | Credit amount for 2006 (cents per kilowatt-hour; dollars per ton) | Credit period for facilities placed in service on or before August 8, 2005 (years from placed-in-service date) | Credit period facilities placed in service after August 8, 2005 (years from placed-in-service date) |
|---|---|---|---|
| Wind | 1.9 | 10 | 10 |
| Closed-loop biomass | 1.9 | 10 [1] | 10 [1] |
| Open-loop biomass (including agricultural livestock waste nutrient facilities) | 0.9 | 5 [2] | 10 |
| Geothermal | 1.9 | 5 | 10 |
| Solar | 1.9 | 5 | 10 |
| Small irrigation power | 0.9 | 5 | 10 |
| Municipal solid waste (including landfill gas facilities and trash combustion facilities) | 0.9 | 5 | 10 |
| Qualified hydropower | 0.9 | N/A | 10 |
| Refined Coal | 5.679 | 10 | 10 |
| Indian Coal | 1.50 | 7 [3] | 7 [3] |

[1] In the case of certain co-firing closed-loop facilities, the credit period begins no earlier than October 22, 2004.

[2] For certain facilities placed in service before October 22, 2004, the 5-year credit period commences on January 1, 2005.

[3] For Indian coal, the credit period begins for coal sold after January 1, 2006.

For eligible pre-existing facilities and other facilities placed in service prior to January 1, 2005, the credit period commences on January 1, 2005. In the case of certain co-firing closed-loop facilities, the credit period begins no earlier than October 22, 2004. For Indian coal, the credit period begins for coal sold after January 1, 2006, for facilities placed-in-service before January 1, 2009.

### *Taxation of cooperatives and their patrons*

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one excep-

tion-the cooperative may exclude from its taxable income distributions of patronage dividends. Generally, cooperatives that are subject to the cooperative tax rules of subchapter T of the Code[1070] are permitted a deduction for patronage dividends from their taxable income only to the extent of net income that is derived from transactions with patrons who are members of the cooperative.[1071] The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative. For taxable years ending on or before August 8, 2005, cooperatives may not pass any portion of the income tax credit for electricity production through to their patrons.

For taxable years ending after August 8, 2005, eligible cooperatives may elect to pass any portion of the credit through to their patrons. An eligible cooperative is defined as a cooperative organization that is owned more than 50 percent by agricultural producers or entities owned by agricultural producers. The credit may be apportioned among patrons eligible to share in patronage dividends on the basis of the quantity or value of business done with or for such patrons for the taxable year. The election must be made on a timely filed return for the taxable year, and once made, is irrevocable for such taxable year. The amount of the credit apportioned to patrons is not included in the organization's credit for the taxable year of the organization. The amount of the credit apportioned to a patron is included in the taxable year the patron with or within which the taxable year of the organization ends. If the amount of the credit for any taxable year is less than the amount of the credit shown on the cooperative's return for such taxable year, an amount equal to the excess of the reduction in the credit over the amount not apportioned to patrons for the taxable year is treated as an increase in the cooperative's tax. The increase is not treated as tax imposed for purposes of determining the amount of any tax credit.

### *Explanation of Provision*

The provision extends through December 31, 2008, the period during which certain facilities may be placed in service as qualified facilities for purposes of the electricity production credit. The placed-in-service date extension applies for all qualified facilities, except for qualified solar, refined coal, and Indian coal facilities.

### *Effective Date*

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

---

[1070] Sec. 1381, et seq.
[1071] Sec. 1382.

## 2. Extension and expansion of clean renewable energy bonds (sec. 202 of the Act and sec. 54 of the Code)

### *Present law*

#### *Tax-exempt bonds*

Interest on State and local governmental bonds generally is excluded from gross income for Federal income tax purposes if the proceeds of the bonds are used to finance direct activities of these governmental units or if the bonds are repaid with revenues of the governmental units. Activities that can be financed with these tax-exempt bonds include the financing of electric power facilities (i.e., generation, transmission, distribution, and retailing).

Interest on State or local government bonds to finance activities of private persons ("private activity bonds") is taxable unless a specific exception is contained in the Code (or in a non-Code provision of a revenue Act). The term "private person" generally includes the Federal government and all other individuals and entities other than States or local governments. The Code includes exceptions permitting States or local governments to act as conduits providing tax-exempt financing for certain private activities. In most cases, the aggregate volume of these tax-exempt private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. For calendar year 2006, these annual volume limits, which are indexed for inflation, equal $80 per resident of the State, or $246.6 million, if greater.

The tax exemption for State and local bonds also does not apply to any arbitrage bond.[1072] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments.[1073] In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal government.

An issuer must file with the IRS certain information about the bonds issued by them in order for that bond issue to be tax-exempt.[1074] Generally, this information return is required to be filed no later the 15th day of the second month after the close of the calendar quarter in which the bonds were issued.

#### *Clean renewable energy bonds*

As an alternative to traditional tax-exempt bonds, States and local governments may issue clean renewable energy bonds ("CREBs"). CREBs are defined as any bond issued by a qualified issuer if, in addition to the requirements discussed below, 95 percent or more of the proceeds of such bonds are used to finance capital expenditures incurred by qualified borrowers for facilities that

[1072] Secs. 103(a) and (b)(2).
[1073] Sec. 148.
[1074] Sec. 149(e).

qualify for the tax credit under section 45 (other than Indian coal production facilities), without regard to the placed-in-service date requirements of that section. The term "qualified issuers" includes (1) governmental bodies (including Indian tribal governments); (2) mutual or cooperative electric companies (described in section 501(c)(12) or section 1381(a)(2)(C), or a not-for-profit electric utility which has received a loan or guarantee under the Rural Electrification Act); and (3) clean energy bond lenders. The term "qualified borrower" includes a governmental body (including an Indian tribal government) and a mutual or cooperative electric company.

In addition, Notice 2006–7, 2006–10 I.R.B. 559, provides that projects that may be financed with CREBs include any facility owned by a qualified borrower that is functionally related and subordinate (as determined under Treas. Reg. sec. 1.103–8(a)(3)) to any qualified facility described in sections 45(d)(1) through (d)(9) (determined without regard to any placed in service date) and owned by such qualified borrower.

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

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

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

To qualify as CREBs, the qualified issuer must reasonably expect to and actually spend 95 percent or more of the proceeds of such bonds on qualified projects within the five-year period that begins on the date of issuance. To the extent less than 95 percent of the proceeds are used to finance qualified projects during the five-year spending period, bonds will continue to qualify as CREBs if unspent proceeds are used within 90 days from the end of such five-year period to redeem any "nonqualified bonds." The five-year spending period may be extended by the Secretary upon the qualified issuer's request demonstrating that the failure to satisfy the five-year requirement is due to reasonable cause and the projects will continue to proceed with due diligence.

Issuers of CREBs are required to report issuance to the IRS in a manner similar to the information returns required for tax-exempt bonds. There is a national CREB limitation of $800 million. CREBs must be issued before January 1, 2008. Under present law,

no more than $500 million of CREBs authority may be allocated to projects for governmental bodies.

### *Explanation of Provision*

The provision authorizes an additional $400 million of CREBs that may be issued and extends the authority to issue such bonds through December 31, 2008. It is expected that the additional authority will be allocated through a new application process similar to that set forth in Notice 2005–98, 2005–52 I.R.B 1211.

In addition to increasing the national limitation on the amount of CREBs, the provision increases the maximum amount of CREBs that may be allocated to qualified projects of governmental bodies to $750 million.

The provision provides an extension of the CREBs program, but it is expected that Congress will review the efficacy of the program, including the efficacy of imposing limitations on allocations to projects for governmental bodies, before granting additional extensions.

### *Effective Date*

The provision authorizing an additional $400 million of CREBs and extending the authority to issue such bonds through December 31, 2008, is effective for bonds issued after December 31, 2006. The provision increasing the maximum amount of CREBs that may be allocated to qualified projects of governmental bodies is effective for allocations or reallocations after December 31, 2006.

## 3. Modification of advanced coal credit with respect to subbituminous coal (sec. 203 of the Act and sec. 48A of the Code)

### *Present Law*

An investment tax credit is available for investments in certain qualifying advanced coal projects (sec. 48A). The credit amount is 20 percent for investments in qualifying projects that use integrated gasification combined cycle ("IGCC"). The credit amount is 15 percent for investments in qualifying projects that use other advanced coal-based electricity generation technologies.

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

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

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

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

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

### *Explanation of Provision*

The provision modifies one of the performance requirements necessary for an electric generation unit to be treated as using advanced coal-based generation technology. Under the provision, the performance requirement relating to the removal of sulfur dioxide is changed so that an electric generation unit designed to use subbituminous coal can meet the standard if it is designed either to remove 99 percent of the sulfur dioxide or to achieve an emission limit of 0.04 pounds of sulfur dioxide per million British thermal units on a 30-day average.

### *Effective Date*

The provision is effective for advanced coal project certification applications submitted after October 2, 2006.

## 4. Extension of energy efficient commercial buildings deduction (sec. 204 of the Act and sec. 179D of the Code)

### *Present Law*

#### *In general*

Code section 179D provides a deduction equal to energy-efficient commercial building property expenditures made by the taxpayer. Energy-efficient commercial building property expenditures is defined as property (1) which is installed on or in any building located in the United States that is within the scope of Standard 90.1–2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America ("ASHRAE/IESNA"), (2) which is installed as

part of (i) the interior lighting systems, (ii) the heating, cooling, ventilation, and hot water systems, or (iii) the building envelope, and (3) which is certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building which meets the minimum requirements of Standard 90.1–2001 (as in effect on April 2, 2003). The deduction is limited to an amount equal to $1.80 per square foot of the property for which such expenditures are made. The deduction is allowed in the year in which the property is placed in service.

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

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

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

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

***Partial allowance of deduction***

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

In the case of system-specific partial deductions, in general no deduction is allowed until the Secretary establishes system-specific targets. However, in the case of lighting system retrofits, until such time as the Secretary issues final regulations, the system-specific

energy savings target for the lighting system is deemed to be met by a reduction in Lighting Power Density of 40 percent (50 percent in the case of a warehouse) of the minimum requirements in Table 9.3.1.1 or Table 9.3.1.2 of ASHRAE/IESNA Standard 90.1–2001. Also, in the case of a lighting system that reduces lighting power density by 25 percent, a partial deduction of 30 cents per square foot is allowed. A pro-rated partial deduction is allowed in the case of a lighting system that reduces lighting power density between 25 percent and 40 percent. Certain lighting level and lighting control requirements must also be met in order to qualify for the partial lighting deductions.

The deduction is effective for property placed in service after December 31, 2005 and prior to January 1, 2008.

### *Explanation of Provision*

The provision extends the deduction to property placed in service prior to January 1, 2009.

### *Effective Date*

The provision is effective on the date of enactment.

## 5. Extension of energy efficient new homes credit (sec. 205 of the Act and sec. 45L of the Code)

### *Present Law*

Code section 45L provides a credit to an eligible contractor for the construction of a qualified new energy-efficient home. To qualify as a new energy-efficient home, the home must be: (1) a dwelling located in the United States, (2) substantially completed after August 8, 2005, and (3) certified in accordance with guidance prescribed by the Secretary to have a projected level of annual heating and cooling energy consumption that meets the standards for either a 30-percent or 50-percent reduction in energy usage, compared to a comparable dwelling constructed in accordance with the standards of chapter 4 of the 2003 International Energy Conservation Code as in effect (including supplements) on August 8, 2005, and any applicable Federal minimum efficiency standards for equipment. With respect to homes that meet the 30-percent standard, one-third of such 30-percent savings must come from the building envelope, and with respect to homes that meet the 50-percent standard, one-fifth of such 50 percent savings must come from the building envelope.

Manufactured homes that conform to Federal manufactured home construction and safety standards are eligible for the credit provided all the criteria for the credit are met. The eligible contractor is the person who constructed the home, or in the case of a manufactured home, the producer of such home.

The credit equals $1,000 in the case of a new home that meets the 30-percent standard and $2,000 in the case of a new home that meets the 50-percent standard. Only manufactured homes are eligible for the $1,000 credit.

In lieu of meeting the standards of chapter 4 of the 2003 International Energy Conservation Code, manufactured homes certified

by a method prescribed by the Administrator of the Environmental Protection Agency under the Energy Star Labeled Homes program are eligible for the $1,000 credit provided criteria (1) and (2), above, are met.

The credit is part of the general business credit. No credits attributable to qualified new energy efficient homes can be carried back to any taxable year ending on or before the effective date of the credit.

The credit applies to homes whose construction is substantially completed after December 31, 2005, and which are purchased after December 31, 2005 and prior to January 1, 2008.

### *Explanation of Provision*

The provision extends the credit to homes whose construction is substantially completed after December 31, 2005, and which are purchased after December 31, 2005 and prior to January 1, 2009.

### *Effective Date*

The provision is effective on the date of enactment.

## 6. Extension of credit for residential energy efficient property (sec. 206 of the Act and sec. 25D of the Code)

### *Present Law*

Code section 25D provides a personal tax credit for the purchase of qualified photovoltaic property and qualified solar water heating property that is used exclusively for purposes other than heating swimming pools and hot tubs. The credit is equal to 30 percent of qualifying expenditures, with a maximum credit for each of these systems of property of $2,000. Section 25D also provides a 30 percent credit for the purchase of qualified fuel cell power plants. The credit for any fuel cell may not exceed $500 for each 0.5 kilowatt of capacity.

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

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

Certain equipment safety requirements need to be met to qualify for the credit. Special proration rules apply in the case of jointly

owned property, condominiums, and tenant-stockholders in cooperative housing corporations. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

The credit applies to property placed in service after December 31, 2005 and prior to January 1, 2008.

### *Explanation Provision*

The provision extends the credit to property placed in service after December 31, 2005 and prior to January 1, 2009. The provision also clarifies that all property, not just photovoltaic property, that uses solar energy to generate electricity for use in a dwelling unit is qualifying property.

### *Effective Date*

The provision is effective on the date of enactment.

## 7. Extension of business solar and fuel cell energy credit (sec. 207 of the Act and sec. 48 of the Code)

### *Present Law*

#### *In general*

A nonrefundable, 10-percent business energy credit is allowed for the cost of new property that is equipment (1) that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat, or (2) used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage. Property used to generate energy for the purposes of heating a swimming pool is not eligible solar energy property.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of so much of the net regular tax liability as exceeds $25,000 or (2) the tentative minimum tax. An unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39).

In general, property that is public utility property is not eligible for the credit. This rule is waived in the case of telecommunication companies' purchases of fuel cell and microturbine property.

The credit is nonrefundable. The taxpayer's basis in the property is reduced by the amount of the credit claimed.

#### *Special rules for solar energy property*

The credit for solar energy property is increased to 30 percent in the case of periods after December 31, 2005 and prior to January 1, 2008. Additionally, equipment that uses fiber-optic distributed sunlight to illuminate the inside of a structure is solar energy property eligible for the 30-percent credit.

***Fuel cells and microturbines***

The business energy credit also applies for the purchase of qualified fuel cell power plants, but only for periods after December 31, 2005 and prior to January 1, 2008. The credit rate is 30 percent. A qualified fuel cell power plant is an integrated system composed of a fuel cell stack assembly and associated balance of plant components that (1) converts a fuel into electricity using electrochemical means, (2) has an electricity-only generation efficiency of greater than 30 percent. The credit may not exceed $500 for each 0.5 kilowatt of capacity.

The business energy credit also applies for the purchase of qualifying stationary microturbine power plants, but only for periods after December 31, 2005 and prior to January 1, 2008. The credit is limited to the lesser of 10 percent of the basis of the property or $200 for each kilowatt of capacity.

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

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

### *Explanation of Provision*

The provision extends the present law credit at current credit rates through December 31, 2008.

### *Effective Date*

The provision is effective on the date of enactment.

## 8. Special rule for qualified methanol and ethanol fuel produced from coal (sec. 208 of the Act and sec. 4041 of the Code)

### *Present Law*

The term "qualified methanol or ethanol fuel" means any liquid at least 85 percent of which consists of methanol, ethanol or other alcohol produced from coal (including peat). Qualified methanol or ethanol fuel is taxed at a reduced rate. Qualified methanol is taxed at 12.35 cents per gallon. Qualified ethanol is taxed at 13.25 cents per gallon. These reduced rates expire after September 30, 2007.

### *Explanation of Provision*

The provision extends the reduced rates for qualified methanol or ethanol fuel through December 31, 2008.

### *Effective Date*

The provision is effective on the date of enactment.

## 9. Special depreciation allowance for cellulosic biomass ethanol plant property (sec. 209 of the Act and new sec. 168(l) of the Code)

### *Present Law*

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

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs (sec. 179). Present law provides that the maximum amount a taxpayer may expense, for taxable years beginning in 2003 through 2009, is $100,000 of the cost of qualifying property placed in service for the taxable year. 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 2010. In general, under section 179, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. 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), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (section 1400N). Recapture rules generally apply with respect to property that ceases to be qualified property.

Section 179C provides a temporary election to expense 50 percent of the cost of qualified refinery property. Qualified refinery property generally includes assets, located in the United States, used in the refining of liquid fuels: (1) with respect to the construction of which there is a binding construction contract before January 1, 2008; (2) which are placed in service before January 1, 2012; (3) which increase the output capacity of an existing refinery by at least five percent or increase the percentage of total throughput at-

tributable to qualified fuels (as defined in section 45K(c)) such that it equals or exceeds 25 percent; and (4) which meet all applicable environmental laws in effect when the property is placed in service.

For purposes of section 179C, the term "refinery" refers to facilities the primary purpose of which is the processing of crude oil (whether or not previously refined) or qualified fuels as defined in section 45K(c). The limitation of section 45K(d) requiring domestic production of qualified fuels is not applicable with respect to the definition of refinery under this provision; thus, otherwise qualifying refinery property is eligible even if the primary purpose of the refinery is the processing of oil produced from shale and tar sands outside the United States. The term refinery would include a facility which processes coal or biomass via gas into liquid fuel.

### *Explanation of Provision*

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

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

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

In order for property to qualify for the additional first-year depreciation deduction, it must meet the following requirements. The original use of the property must commence with the taxpayer on or after the date of enactment of the provision. The property must be acquired by purchase (as defined under section 179(d)) by the taxpayer after the date of enactment and placed in service before January 1, 2013. Property does not qualify if a binding written contract for the acquisition of such property was in effect on or before the date of enactment.

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

the date of enactment, and the property is placed in service before January 1, 2013 (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Property any portion of which is financed with the proceeds of a tax-exempt obligation under section 103 is not eligible for the additional first-year depreciation deduction. Recapture rules apply under the provision if the property ceases to be qualified cellulosic biomass ethanol plant property.

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

### *Effective Date*

The provision applies to property placed in service after the date of enactment, in taxable years ending after such date.

## 10. Expenditures permitted from the Leaking Underground Storage Tank Trust Fund (sec. 210 of the Act and sec. 9508 of the Code)

### *Present Law*

#### *Internal Revenue Code provisions*

Section 1362 of the Energy Policy Act of 2005[1075] extended the 0.1 cent per-gallon Leaking Underground Storage Tank ("LUST") Trust Fund tax until October 1, 2011. Under section 9508 of the Internal Revenue Code (the "Code"), the LUST Trust Fund is available only for purposes specified in section 9003(h) of the Solid Waste Disposal Act as in effect on the date of enactment of the Superfund Amendments and Reauthorization Act of 1986.[1076]

All expenditures from the LUST Trust Fund must be authorized by the Code. In the event of an expenditure from the LUST Trust Fund that is not authorized by the Code, the Code provides that no amounts may be appropriated to the LUST Trust Fund on or after the date of such expenditure. An exception to this rule is provided to allow for the liquidation of contracts entered into in accordance with the Code before October 1, 2011. The determination of whether an expenditure is permitted is to be made without regard to (1) any provision of law that is not contained or referenced in the Code or in a revenue Act, and (2) whether such provision of law is a subsequently enacted provision or directly or indirectly seeks to waive the application of the Code restriction. This provision became effective on August 10, 2005.[1077]

#### *Underground Storage Tank Compliance Act of 2005*

Sections 1521 through 1533 of the Energy Policy Act of 2005 (also known as the "Underground Storage Tank Compliance Act of

[1075] Pub. L. No. 109–58.
[1076] Sec. 9508(c).
[1077] Sec. 9508(e). This provision was added to the Code by section 11147 of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (Pub. L. No. 109–59).

2005") broadened the uses of the LUST Trust Fund and authorizes States and the Environmental Protection Agency ("EPA") to use funds appropriated from the LUST Trust Fund to address methyl tertiary butyl ether ("MTBE") leaks.[1078]

Section 1522 directs EPA to allot at least 80 percent of the funds made available from the LUST Trust Fund to the States for the LUST cleanup program (section 9004 of the Solid Waste Disposal Act). It also requires EPA or States to conduct compliance inspections of underground storage tanks every three years (sec. 1523 (section 9005(c) of the Solid Waste Disposal Act)); adds operator training requirements (sec. 1524 (section 9010 of the Solid Waste Disposal Act)); and authorizes EPA and States to use LUST Trust Fund money to respond to tank leaks involving oxygenated fuel additives (e.g., MTBE and ethanol) (sec. 1525 (section 9003(h) of the Solid Waste Disposal Act)). Section 1526 authorizes EPA and States to use LUST Trust Fund money to conduct inspections and enforce tank release prevention and detection requirements (sections 9011 and 9003(j) of the Solid Waste Disposal Act). The Act also prohibits fuel delivery to ineligible tanks (sec. 1527 (section 9012 of the Solid Waste Disposal Act)); and requires EPA, with Indian tribes, to develop and implement a strategy to address releases on tribal lands (sec. 1529 (section 9013 of the Solid Waste Disposal Act)).

Sec. 1530 (section 9003(i) of the Solid Waste Disposal Act) requires States to do one of the following to protect groundwater: (1) require that new tanks are secondarily contained and monitored for leaks if the tank is within 1,000 feet of a community water system or potable well; or (2) require that underground storage tank manufacturers and installers maintain evidence of financial responsibility to pay for corrective actions. It also requires that persons installing underground storage tank systems are certified or licensed, or that their underground storage tank system installation is certified by a professional engineer or inspected and approved by the State, or is compliant with a code of practice or other method that is no less protective of human health and the environment.

Sec. 1531 (section 9014 of the Solid Waste Disposal Act) authorized to be appropriated from the LUST Trust Fund, for each of FY2005 through FY2009, $200 million for cleaning up leaks from petroleum tanks generally, and another $200 million for responding to tank leaks involving MTBE or other oxygenated fuel additives (e.g., other ethers and ethanol). This section further authorizes to be appropriated from the LUST Trust Fund, for each of FY2005 through FY2009, $155 million for EPA and States to carry out and enforce the underground storage tank leak prevention and detection requirements added by the Act and the LUST cleanup program.[1079]

---

[1078] The description that follows is taken primarily from Congressional Research Service, *Energy Policy Act of 2005: Summary and Analysis of Enacted Provisions* (March 8, 2006).

[1079] Section 9014 provides in pertinent part: There are authorized to be appropriated to the Administrator the following amounts: . . .

(2) From the Trust Fund, notwithstanding section 9508(c)(1) of the Internal Revenue Code of 1986:

(A) to carry out section 9003(h) (except section 9003(h)(12) $200,000,000 for each of fiscal years 2005 through 2009;

(B) to carry out section 9003(h)(12), $200,000,000 for each of fiscal years 2005 through 2009;

These provisions became effective on the date of enactment (August 8, 2005).

Public Law No. 109–168 made certain technical corrections to the Solid Waste Disposal Act as amended by the Energy Policy Act of 2005 with respect to the regulation of underground storage tanks and government-owned tanks. It also adjusted and extended the authorization for appropriations to cover fiscal year 2006 through fiscal year 2011.

Although the Underground Storage Tank Compliance Act of 2005 and Public Law No. 109–168 amended the Solid Waste Disposal Act, neither Act made conforming amendments to section 9508 of the Code.

### *Explanation of Provision* [1080]

The provision updates the permitted expenditure purposes of Code section 9508(c) to include the purposes added by the Energy Policy Act of 2005. Specifically, the provision authorizes LUST Trust Fund amounts to be used to carry out the following provisions of the Solid Waste Disposal Act (as in effect on January 10, 2006, the date of enactment of Pub. L. No. 109–168):

- section 9003(i) (relating to measures to protect ground water);
- section 9003(j) (relating to compliance of government-owned tanks);
- section 9004(f) (relating to 80 percent distribution requirement for State enforcement efforts);
- section 9005(c) (relating to inspection of underground storage tanks);
- section 9010 (relating to operator training);
- section 9011 (relating to funds for release prevention and compliance);
- section 9012 (relating to the delivery prohibition for ineligible tanks/guidance/compliance); and
- section 9013 (relating to strategy for addressing tanks on tribal lands).

The Code continues to authorize the use of amounts in the LUST Trust Fund to carry out the purposes of section 9003(h) of the Solid Waste Disposal Act (as in effect on January 10, 2006, the date of enactment of Pub. L. No. 109–168).

### *Effective Date*

The provision is effective on the date of enactment.

---

(C) to carry out sections 9003(i), 9004(f), and 9005(c) $100,000,000 for each of fiscal years 2005 through 2009, and

(D) to carry out sections 9010, 9011, 9012, and 9013 $55,000,000 for each of fiscal years 2005 through 2009.

[1080] An identical provision was enacted by H.R. 6131. The House passed H.R. 6131 on the suspension calendar on September 26, 2006. The Senate passed the bill without an amendment by unanimous consent on December 8, 2006. The President signed the bill on December 20, 2006 (Pub. L. No. 109–433).

## 11. Modification of credit for fuel from a non-conventional source (sec. 211 of the Act and sec. 45K of the Code)

### *Present Law*

Certain fuels produced from "non-conventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation)[1081] per barrel or Btu oil barrel equivalent ("non-conventional source fuel credit").[1082] Qualified fuels must be produced within the United States.

Qualified fuels include:

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

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

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

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

### *Explanation of Provision*

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

---

[1081] The inflation adjustment is generally calculated using 1979 as the base year. Generally, the value of the credit for fuel produced in 2005 was $6.79 per barrel-of-oil equivalent produced, which is approximately $1.20 per thousand cubic feet of natural gas. In the case of fuel sold after 2005, the credit for coke or coke gas is indexed for inflation using 2004 as the base year instead of 1979.

[1082] Sec. 29 (for tax years ending before 2006); sec. 45K (for tax years ending after 2005).

***Effective Date***

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

## TITLE III—HEALTH SAVINGS ACCOUNTS

### 1. Provisions relating to health savings accounts (secs. 301–307 of the Act and sec. 223 of the Code)

#### *Present Law*

#### *Health savings accounts*

*In general*

Individuals with a high deductible health plan (and no other health plan other than a plan that provides certain permitted coverage) may establish a health savings account ("HSA"). In general, HSAs provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. In general, HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents.

Within limits, contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual. Contributions to an HSA are excludable from income and employment taxes if made by the employer. Earnings on amounts in HSAs are not taxable. Distributions from an HSA for qualified medical expenses are not includible in gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 10 percent. The 10-percent additional tax does not apply if the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

*Eligible individuals*

Eligible individuals for HSAs are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan and which provides coverage for any benefit which is covered under the high deductible health plan. After an individual has attained age 65 and becomes enrolled in Medicare benefits, contributions cannot be made to an HSA.[1083] Individuals who may be claimed as a dependent on another person's tax return may not make contributions to an HSA.

An individual with other coverage in addition to a high deductible health plan is still eligible for an HSA if such other coverage is certain permitted insurance or permitted coverage. Permitted insurance is: (1) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such

[1083] Sec. 223(b)(7), as interpreted by Notice 2004–2, 2004–2 I.R.B. 269, corrected by Announcement 2004–67, 2004–36 I.R.B. 459.

other similar liabilities as the Secretary of Treasury may prescribe by regulations; (2) insurance for a specified disease or illness; and (3) insurance that provides a fixed payment for hospitalization. Permitted coverage is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

A high deductible health plan is a health plan that, for 2007, has a deductible that is at least $1,100 for self-only coverage or $2,200 for family coverage and that has an out-of-pocket expense limit that is no more than $5,500 in the case of self-only coverage and $11,000 in the case of family coverage.[1084] Out-of-pocket expenses include deductibles, co-payments, and other amounts (other than premiums) that the individual must pay for covered benefits under the plan. A plan is not a high deductible health plan if substantially all of the coverage is for permitted coverage or coverage that may be provided by permitted insurance, as described above. A plan does not fail to be a high deductible health plan by reason of failing to have a deductible for preventive care.

Health flexible spending arrangements ("FSAs") and health reimbursement arrangements ("HRAs") are health plans that constitute other coverage under the HSA rules. These arrangements are discussed in more detail, below. An individual who is covered by a high deductible health plan and a health FSA or HRA generally is not eligible to make contributions to an HSA. An individual is eligible to make contributions to an HSA if the health FSA or HRA is: (1) a limited purpose health FSA or HRA; (2) a suspended HRA; (3) a post-deductible health FSA or HRA; or (4) a retirement HRA.[1085]

*Tax treatment of and limits on contributions*

Contributions to an HSA by or on behalf of an eligible individual are deductible (within limits) in determining adjusted gross income (i.e., "above-the-line") of the individual. In addition, employer contributions to HSAs (including salary reduction contributions made through a cafeteria plan) are excludable from gross income and wages for employment tax purposes. In the case of an employee, contributions to an HSA may be made by both the individual and the individual's employer. All contributions are aggregated for purposes of the maximum annual contribution limit. Contributions to Archer MSAs reduce the annual contribution limit for HSAs.

---

[1084] The limits are indexed for inflation. For 2006, a high deductible plan is a health plan that has a deductible that is at least $1,050 for self-only coverage or $2,100 for family coverage and that has an out-of-pocket expense limit that is no more than $5,250 in the case of self-only coverage and $10,500 in the case of family coverage. The family coverage limits always will be twice the self-only coverage limits (as indexed for inflation). In the case of the plan using a network of providers, the plan does not fail to be a high deductible health plan (if it would otherwise meet the requirements of a high deductible health plan) solely because the out-of-pocket expense limit for services provided outside of the network exceeds the out-of-pocket expense limits. In addition, such plan's deductible for out-of-network services is not taken into account in determining the annual contribution limit (i.e., the deductible for services within the network is used for such purpose).

[1085] Rev. Rul. 2004–45, 2004–22 I.R.B. 1. A limited purpose health FSA pays or reimburses benefits for permitted coverage and a limited purpose HRA pays or reimburses benefits for permitted insurance or permitted coverage. A limited purpose health FSA or HRA may also pay or reimburse preventive care benefits. A suspended HRA does not pay medical expense incurred during a suspension period except for preventive care, permitted insurance and permitted coverage. A post-deductible health FSA or HRA does not pay or reimburse any medical expenses incurred before the minimum annual deductible under the HSA rules is satisfied. A retirement HRA pays or reimburses only medical expenses incurred after retirement.

The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100 percent of the annual deductible under the high deductible health plan, or (2) (for 2007) $2,850 in the case of self-only coverage and $5,650 in the case of family coverage.[1086] The annual contribution limit is the sum of the limits determined separately for each month, based on the individual's status and health plan coverage as of the first day of the month. The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year. In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by $700 in 2006, $800 in 2007, $900 in 2008, and $1,000 in 2009 and thereafter. As in determining the general annual contribution limit, the increase in the annual contribution limit for individuals who have attained age 55 is also determined on a monthly basis. As previously discussed, contributions, including catch-up contributions, cannot be made once an individual is enrolled in Medicare.

In the case of individuals who are married to each other and either spouse has family coverage, both spouses are treated as having only the family coverage with the lowest annual deductible. The annual contribution limit (without regard to the catch-up contribution amounts) is divided equally between the spouses unless they agree on a different division (after reduction for amounts paid from any Archer MSA of the spouses).

An excise tax applies to contributions in excess of the maximum contribution amount for the HSA. The excise tax generally is equal to six percent of the cumulative amount of excess contributions that are not distributed from the HSA.

Amounts can be rolled over into an HSA from another HSA or from an Archer MSA.

*Comparable contributions*

If an employer makes contributions to employees' HSAs, the employer must make available comparable contributions on behalf of all employees with comparable coverage during the same period. Contributions are considered comparable if they are either of the same amount or the same percentage of the deductible under the plan. If employer contributions do not satisfy the comparability rule during a period, then the employer is subject to an excise tax equal to 35 percent of the aggregate amount contributed by the employer to HSAs for that period. The comparability rule does not apply to contributions made through a cafeteria plan.

*Taxation of distributions*

Distributions from an HSA for qualified medical expenses of the individual and his or her spouse or dependents generally are excludable from gross income. In general, amounts in an HSA can be used for qualified medical expenses even if the individual is not currently eligible for contributions to the HSA.

[1086] These amounts are indexed for inflation. For 2006, the dollar limits are $2,700 in the case of self-only coverage and $5,450 in the case of family coverage.

Qualified medical expenses generally are defined as under section 213(d) and include expenses for diagnosis, cure, mitigation, treatment, or prevention of disease. Qualified medical expenses do not include expenses for insurance other than for (1) long-term care insurance, (2) premiums for health coverage during any period of continuation coverage required by Federal law, (3) premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law, or (4) in the case of an account beneficiary who has attained the age of Medicare eligibility, health insurance premiums for Medicare, other than premiums for Medigap policies. Such qualified health insurance premiums include, for example, Medicare Part A and Part B premiums, Medicare HMO premiums, and the employee share of premiums for employer-sponsored health insurance including employer-sponsored retiree health insurance. Whether the expenses are qualified medical expenses is determined as of the time the expenses were incurred.

For purposes of determining the itemized deduction for medical expenses, distributions from an HSA for qualified medical expenses are not treated as expenses paid for medical care under section 213. Distributions from an HSA that are not for qualified medical expenses are includible in gross income. Distributions includible in gross income also are subject to an additional 10-percent tax unless made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

*Reporting requirements*

Employer contributions are required to be reported on the employee's Form W–2. Trustees of HSAs may be required to report to the Secretary of the Treasury amounts with respect to contributions, distributions, the return of excess contributions, and other matters as determined appropriate by the Secretary. In addition, the Secretary may require providers of high deductible health plans to make reports to the Secretary and to account beneficiaries as the Secretary determines appropriate.

### *Health flexible spending arrangements and health reimbursement arrangements*

Arrangements commonly used by employers to reimburse medical expenses of their employees (and their spouses and dependents) include health flexible spending arrangements ("FSAs") and health reimbursement accounts ("HRAs"). Health FSAs typically are funded on a salary reduction basis, meaning that employees are given the option to reduce current compensation and instead have the compensation used to reimburse the employee for medical expenses. If the health FSA meets certain requirements, then the compensation that is forgone is not includible in gross income or wages and reimbursements for medical care from the health FSA are excludable from gross income and wages. Health FSAs are subject to the general requirements relating to cafeteria plans, including a requirement that a cafeteria plan generally may not provide

deferred compensation.[1087] This requirement often is referred to as the "use-it-or-lose-it-rule." Until May of 2005, this requirement was interpreted to mean that amounts available from a health FSA as of the end of a plan year must be forfeited by the employee. In May 2005, the Treasury Department issued a notice that allows a grace period not to exceed two and one-half months immediately following the end of the plan year during which unused amounts may be used.[1088] An individual participating in a health FSA that allows reimbursements during a grace period is generally not eligible to make contributions to the HSA until the first month following the end of the grace period even if the individual's health FSA has no unused benefits as of the end of the prior plan year.[1089] Health FSAs are subject to certain other requirements, including rules that require that the FSA have certain characteristics similar to insurance.

HRAs operate in a manner similar to health FSAs, in that they are an employer-maintained arrangement that reimburses employees for medical expenses. Some of the rules applicable to HRAs and health FSAs are similar, e.g., the amounts in the arrangements can only be used to reimburse medical expenses and not for other purposes. Some of the rules are different. For example, HRAs cannot be funded on a salary reduction basis and the use-it-or lose-it rule does not apply. Thus, amounts remaining at the end of the year may be carried forward to be used to reimburse medical expenses in the next year.[1090] Reimbursements for insurance covering medical care expenses are allowable reimbursements under an HRA, but not under a health FSA.

As mentioned above, subject to certain limited exceptions, health FSAs and HRAs constitute other coverage under the HSA rules.

### *Explanation of Provision*

#### *Allow rollovers from health FSAs and HRAs into HSAs for a limited time*

The provision allows certain amounts in a health FSA or HRA to be distributed from the health FSA or HRA and contributed through a direct transfer to an HSA without violating the otherwise applicable requirements for such arrangements. The amount that can be distributed from a health FSA or HRA and contributed to an HSA may not exceed an amount equal to the lesser of (1) the balance in the health FSA or HRA as of September 21, 2006 or (2) the balance in the health FSA or HRA as of the date of the distribution. The balance in the health FSA or HRA as of any date is determined on a cash basis (i.e., expenses incurred that have not been reimbursed as of the date the determination is made are not taken into account). Amounts contributed to an HSA under the provision are excludable from gross income and wages for employment tax purposes, are not taken into account in applying the maximum deduction limitation for other HSA contributions, and are not deductible. Contributions must be made directly to the HSA before

[1087] Sec. 125(d)(2).
[1088] Notice 2005–42, 2005–23 I.R.B. 1204.
[1089] Notice 2005–86, 2005–49 I.R.B. 1075.
[1090] Guidance with respect to HRAs, including the interaction of health FSAs and HRAs in the case an individual is covered under both, is provided in Notice 2002–45, 2002–2 C.B. 93.

January 1, 2012. The provision is limited to one distribution with respect to each health FSA or HRA of the individual.

The provision is designed to assist individuals in transferring from another type of health plan to a high deductible health plan. Thus, if an individual for whom a contribution is made under the provision does not remain an eligible individual during the testing period, the amount of the contribution is includible in gross income of the individual. An exception applies if the employee ceases to be an eligible individual by reason of death or disability. The testing period is the period beginning with the month of the contribution and ending on the last day of the 12th month following such month. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual. A 10-percent additional tax also applies to the amount includible.

A modified comparability rule applies with respect to contributions under the provision. If the employer makes available to any employee the ability to make contributions to the HSA from distributions from a health FSA or HRA under the provision, all employees who are covered under a high deductible plan of the employer must be allowed to make such distributions and contributions. The present-law excise tax applies if this requirement is not met.

For example, suppose the balance in a health FSA as of September 21, 2006, is $2,000 and the balance in the account as January 1, 2008 is $3,000. Under the provision, a health FSA will not be considered to violate applicable rules if, as of January 1, 2008, an amount not to exceed $2,000 is distributed from the health FSA and contributed to an HSA of the individual. The $2,000 distribution would not be includible in income, and the subsequent contribution would not be deductible and would not count against the annual maximum tax deductible contribution that can be made to the HSA. If the individual ceases to be an eligible individual as of June 1, 2008, the $2,000 contribution amount is included in gross income and subject to a 10- percent additional tax. If instead the distribution and contribution are made as of June 30, 2008, when the balance in the health FSA is $1,500, the amount of the distribution and contribution is limited to $1,500.

The present law rule that an individual is not an eligible individual if the individual has coverage under a general purpose health FSA or HRA continues to apply. Thus, for example, if the health FSA or HRA from which the contribution is made is a general purpose health FSA or HRA and the individual remains eligible under such arrangement after the distribution and contribution, the individual is not an eligible individual.

### *Certain FSA coverage treated as disregarded coverage*

The provision provides that, for taxable years beginning after December 31, 2006, in certain cases, coverage under a health flexible spending arrangement ("FSA") during the period immediately following the end of a plan year during which unused benefits or contributions remaining at the end of such plan year may be paid or reimbursed to plan participants for qualified expenses is disregarded coverage. Such coverage is disregarded if (1) the balance

in the health FSA at the end of the plan year is zero, or (2) in accordance with rules prescribed by the Secretary of Treasury, the entire remaining balance in the health FSA at the end of the plan year is contributed to an HSA as provided under another provision of the Act.[1091]

Thus, for example, if as of December 31, 2006, a participant's health FSA balance is zero, coverage under the health FSA during the period from January 1, 2007, until March 15, 2007 (i.e., the "grace period") is disregarded in determining if tax deductible contributions can be made to an HSA for that period. Similarly, if the entire balance in an individual's health FSA as of December 31, 2006, is distributed and contributed to an HSA (as under another provision of the Act) coverage during the health FSA grace period is disregarded.

It is intended that the Secretary will provide guidance under the provision with respect to the timing of health FSA distributions contributed to an HSA in order to facilitate such rollovers and the establishment of HSAs in connection with high deductible plans. For example, it is intended that the Secretary would provide rules under which coverage is disregarded if, before the end of a year, an individual elects high deductible plan coverage and to contribute any remaining FSA balance to an HSA in accordance with the provision even if the trustee-to-trustee transfer cannot be completed until the following plan year. Similar rules apply for the general provision allowing amounts from a health FSA or HRA to be contributed to an HSA in order to facilitate such contributions at the beginning of an employee's first year of HSA eligibility.

The provision does not modify the permitted health FSA grace period allowed under existing Treasury guidance.

### *Repeal of annual plan deductible limitation on HSA contribution limitation*

The provision modifies the limit on the annual deductible contributions that can be made to an HSA so that the maximum deductible contribution is not limited to the annual deductible under the high deductible health plan. Thus, under the provision, the maximum aggregate annual contribution that can be made to an HSA is $2,850 (for 2007) in the case of self-only coverage and $5,650 (for 2007) in the case of family coverage.

### *Earlier indexing of cost of living adjustments*

Under the provision, in the case of adjustments made for any taxable year beginning after 2007, the Consumer Price Index for a calendar year is determined as of the close of the 12-month period ending on March 31 of the calendar year (rather than August 31 as under present law) for the purpose of making cost-of-living adjustments for the HSA dollar amounts that are indexed for inflation (i.e., the contribution limits and the high-deductible health plan requirements). The provision also requires the Secretary of Treasury to publish the adjusted amounts for a year no later than June 1 of the preceding calendar year.

---

[1091] The amount that can be contributed is limited to the balance in the health FSA as of September 21, 2006.

***Allow full contribution for months preceding month that taxpayer is an eligible individual***

In general, the provision allows individuals who become covered under a high deductible plan in a month other than January to make the full deductible HSA contribution for the year. Under the provision, an individual who is an eligible individual during the last month of a taxable year is treated as having been an eligible individual during every month during the taxable year for purposes of computing the amount that may be contributed to the HSA for the year. Thus, such individual is allowed to make contributions for months before the individual was enrolled in a high deductible health plan. For the months preceding the last month of the taxable year that the individual is treated as an eligible individual solely by reason of the provision, the individual is treated as having been enrolled in the same high deductible health plan in which the individual was enrolled during the last month of the taxable year.

If an individual makes contributions under the provision and does not remain an eligible individual during the testing period, the amount of the contributions attributable to months preceding the month in which the individual was an eligible individual which could not have been made but for the provision are includible in gross income. An exception applies if the employee ceases to be an eligible individual by reason of death or disability. The testing period is the period beginning with the last month of the taxable year and ending on the last day of the 12th month following such month. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual. A 10-percent additional tax also applies to the amount includible.

For example, suppose individual "A" enrolls in high deductible plan "H" in December of 2007 and is otherwise an eligible individual in that month. A was not an eligible individual in any other month in 2007. A may make HSA contributions as if she had been enrolled in plan H for all of 2007. If A ceases to be an eligible individual (e.g., if she ceases to be covered under the high deductible health plan) in June 2008, an amount equal to the HSA deduction attributable to treating A as an eligible individual for January through November 2007 is included in income in 2008. In addition, a 10-percent additional tax applies to the amount includible.

***Modify employer comparable contribution requirements for contributions made to nonhighly compensated employees***

The provision provides an exception to the comparable contribution requirements which allows employers to make larger HSA contributions for nonhighly compensated employees than for highly compensated employees. Highly compensated employees are defined as under section 414(q) and include any employee who was (1) a five-percent owner at any time during the year or the preceding year; or (2) for the preceding year, (A) had compensation from the employer in excess of $100,000[1092] (for 2007) and (B) if

[1092] This amount is indexed for inflation.

elected by the employer, was in the group consisting of the top–20 percent of employees when ranked based on compensation. Nonhighly compensated employees are employees not included in the definition of highly compensated employee under section 414(q).

The comparable contribution rules continue to apply to the contributions made to nonhighly compensated employees so that the employer must make available comparable contributions on behalf of all nonhighly compensated employees with comparable coverage during the same period.

For example, an employer is permitted to make a $1,000 contribution to the HSA of each nonhighly compensated employee for a year without making contributions to the HSA of each highly compensated employee.

***One-time rollovers from IRAs into HSAs***

The provision allows a one-time contribution to an HSA of amounts distributed from an individual retirement arrangement ("IRA"). The contribution must be made in a direct trustee- to-trustee transfer. Amounts distributed from an IRA under the provision are not includible in income to the extent that the distribution would otherwise be includible in income. In addition, such distributions are not subject to the 10-percent additional tax on early distributions.

In determining the extent to which amounts distributed from the IRA would otherwise be includible in income, the aggregate amount distributed from the IRA is treated as includible in income to the extent of the aggregate amount which would have been includible if all amounts were distributed from all IRAs of the same type (i.e., in the case of a traditional IRA, there is no pro-rata distribution of basis). As under present law, this rule is applied separately to Roth IRAs and other IRAs.

The amount that can be distributed from the IRA and contributed to an HSA is limited to the otherwise maximum deductible contribution amount to the HSA computed on the basis of the type of coverage under the high deductible health plan at the time of the contribution. The amount that can otherwise be contributed to the HSA for the year of the contribution from the IRA is reduced by the amount contributed from the IRA. No deduction is allowed for the amount contributed from an IRA to an HSA.

Under the provision, only one distribution and contribution may be made during the lifetime of the individual, except that if a distribution and contribution are made during a month in which an individual has self-only coverage as of the first day of the month, an additional distribution and contribution may be made during a subsequent month within the taxable year in which the individual has family coverage. The limit applies to the combination of both contributions.

If the individual does not remain an eligible individual during the testing period, the amount of the distribution and contribution is includible in gross income of the individual. An exception applies if the employee ceases to be an eligible individual by reason of death or disability. The testing period is the period beginning with the month of the contribution and ending on the last day of the 12th month following such month. The amount is includible for the

taxable year of the first day during the testing period that the individual is not an eligible individual. A 10-percent additional tax also applies to the amount includible.

The provision does not apply to simplified employee pensions ("SEPs") or to SIMPLE retirement accounts.

### *Effective Date*

The provision allowing rollovers from heath FSAs and HRAs into HSAs is effective for distributions and contributions on or after the date of enactment and before January 1, 2012. The provision disregarding certain FSA coverage is effective after the date of enactment with respect to coverage for taxable years beginning after December 31, 2006. The provision repealing the annual plan limitation on the HSA contribution limitation is effective for taxable years beginning after December 31, 2006. The provision relating to cost-of-living adjustments is effective for adjustments made for taxable years beginning after 2007. The provision allowing contributions for months preceding the month that the taxpayer is an eligible individual is effective for taxable years beginning after December 31, 2006. The provision modifying the comparability rule is effective for taxable years beginning after December 31, 2006. The provision allowing one-time rollovers from an IRA into an HSA is effective for taxable years beginning after December 31, 2006.

## TITLE IV—OTHER TAX PROVISIONS

### 1. Deduction allowable with respect to income attributable to domestic production activities in Puerto Rico (sec. 401 of the Act and sec. 199 of the Code)

#### *Present Law*

***In general***

Present law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's qualified production activities income. For taxable years beginning after 2009, the deduction is nine percent of such income. For taxable years beginning in 2005 and 2006, the deduction is three percent of income and, for taxable years beginning in 2007, 2008 and 2009, the deduction is six percent of income. For taxpayers subject to the 35-percent corporate income tax rate, the 9-percent deduction effectively reduces the corporate income tax rate to just under 32 percent on qualified production activities income.

***Qualified production activities income***

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

***Domestic production gross receipts***

"Domestic production gross receipts" generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property [1093] that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States; (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film [1094] produced by the taxpayer; (3) any sale, exchange or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction activities performed in the United States; or (5) engineering or architectural services performed in the United States for construction projects located in the United States.

---

[1093] "Qualifying production property" generally includes any tangible personal property, computer software, or sound recordings.

[1094] "Qualified film" includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of such film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

For purposes of section 199, the United States does not include Puerto Rico or other U.S. possessions.[1095]

***Wage limitation***

For taxable years beginning after May 17, 2006, the amount of the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.[1096] Wages paid to bona fide residents of Puerto Rico generally are not included in the wage limitation amount.[1097]

### *Explanation of Provision*

The provision amends section 199 of the Code to include Puerto Rico within the definition of the United States for purposes of determining the domestic production gross receipts of eligible taxpayers. Under the provision, a taxpayer is allowed to treat Puerto Rico as part of the United States for purposes of section 199 (thus allowing the taxpayer to take into account its Puerto Rico business activity for purposes of calculating its domestic production gross receipts and qualified production activities income), but only if all of the taxpayer's gross receipts from sources within Puerto Rico are currently taxable for U.S. Federal income tax purposes. Consequently, a controlled foreign corporation is not eligible for the section 199 deduction made available by the provision. In addition, any such taxpayer is also allowed to take into account wages paid to bona fide residents of Puerto Rico for purposes of calculating the 50-percent wage limitation.

### *Effective Date*

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

## 2. Alternative minimum tax credit relief for individuals; returns required for certain options (secs. 402 and 403 of the Act and secs. 53 and 6039 of the Code)

### *Present Law*

***In general***

Present law imposes an alternative minimum tax ("AMT") on an individual taxpayer to the extent the taxpayer's tentative minimum tax liability exceeds his or her regular income tax liability. An individual's tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is

[1095] Sec. 7701(a)(9) ("the term 'United States' when used in a geographical sense includes only the States and the District of Columbia").

[1096] For purposes of the provision, "wages" include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. For taxable years beginning before May 18, 2006, the limitation is based upon all wages paid by the taxpayer, rather than only wages properly allocable to domestic production gross receipts.

[1097] Sec. 3401(a)(8)(C).

the amount by which the alternative minimum taxable income ("AMTI") exceeds an exemption amount.

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

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

### *AMT treatment of incentive stock options*

One of the adjustments in computing AMTI is the tax treatment of the exercise of an incentive stock option. An incentive stock option is an option granted by a corporation in connection with an individual's employment, so long as the option meets certain specified requirements.[1098] Under the regular tax, the exercise of an incentive stock option is tax-free if the stock is not disposed of within one year of exercise of the option or within two years of the grant of the option.[1099] The individual then computes the long-term capital gain or loss on the sale of the stock using the amount paid for the stock as the cost basis. If the holding period requirements are not satisfied, the individual generally takes into account at the exercise of the option an amount of ordinary income equal to the excess of the fair market value of the stock on the date of exercise over the amount paid for the stock. The cost basis of the stock is increased by the amount taken into account.[1100]

Under the individual alternative minimum tax, the exercise of an incentive stock option is treated as the exercise of an option other than an incentive stock option. Under this treatment, generally the individual takes into account as ordinary income for purposes of computing AMTI the excess of the fair market value of the stock at the date of exercise over the amount paid for the stock.[1101] When the stock is later sold, for purposes of computing capital gain or loss for purposes of AMTI, the adjusted basis of the stock includes the amount taken into account as AMTI.

The adjustment relating to incentive stock options is a deferral adjustment and therefore generates an AMT credit in the year the stock is sold.[1102]

---

[1098] Sec. 422.

[1099] Sec. 421.

[1100] If the stock is sold at a loss before the required holding periods are met, the amount taken into account may not exceed the amount realized on the sale over the adjusted basis of the stock. If the stock is sold after the taxable year in which the option was exercised but before the required holding periods are met, the required inclusion is made in the year the stock is sold.

[1101] If the stock is sold in the same taxable year the option is exercised, no adjustment in computing AMTI is required.

[1102] If the stock is sold for less than the amount paid for the stock, the loss may not be allowed in full in computing AMTI by reason of the $3,000 limit on the deductibility of net capital losses. Thus, the excess of the regular tax over the tentative minimum tax may not reflect the full amount of the loss.

### *Furnishing of information*

Under present law,[1103] employers are required to provide to employees information regarding the transfer of stock pursuant to the exercise of an incentive stock option and to transfers of stock under an employee stock purchase plan where the option price is between 85 percent and 100 percent of the value of the stock.[1104]

## *Explanation of Provision*

### *Allowance of credit*

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

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

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

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

---

[1103] Sec. 6039.
[1104] Sec. 423(c).

### *Information returns*

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

### *Effective Date*

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

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

## 3. Partial expensing for advanced mine safety equipment (sec. 404 of the Act and new sec. 179E of the Code)

### *Present Law*

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

Personal property is classified under MACRS based on the property's class life unless a different classification is specifically provided in section 168. The class life applicable for personal property is the asset guideline period (midpoint class life as of January 1, 1986). Based on the property's classification, a recovery period is prescribed under MACRS. In general, there are six classes of recovery periods to which personal property can be assigned. For example, personal property that has a class life of four years or less has a recovery period of three years, whereas personal property with a class life greater than four years but less than 10 years has a recovery period of five years. The class lives and recovery periods for most property are contained in Revenue Procedure 87–56.[1105]

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

[1105] 1987–2 C.B. 674 (as clarified and modified by Rev. Proc. 88–22, 1988–1 C.B. 785).

### *Explanation of Provision*

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

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

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

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

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

An election made by the taxpayer under the provision may not be revoked except with the consent of the Secretary.

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

### *Effective Date*

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

## 4. Mine rescue team training credit (sec. 405 of the Act and new sec. 45N of the Code)

### *Present Law*

There is no present law credit for expenditures incurred by a taxpayer to train mine rescue workers. In general, a deduction is allowed for all ordinary and necessary expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any

trade or business.[1106] A taxpayer that employs individuals as miners in underground mines will generally be permitted to deduct as ordinary and necessary expenses the educational expenditures such taxpayer incurs to train its employees in the principles, procedures, and techniques of mine rescue, as well as the wages paid by the taxpayer for the time its employees were engaged in such training.

### *Explanation of Provision*

Under the provision, a taxpayer which is an eligible employer may claim a credit with respect to each qualified mine rescue team employee equal to the lesser of (1) 20 percent of the amount paid or incurred by the taxpayer during the taxable year with respect to the training program costs of such qualified mine rescue team employee (including wages of the employee while attending the program), or (2) $10,000.[1107] For purposes of the provision, "wages" has the meaning given to such term by sec. 3306(b) (determined without regard to any dollar limitation contained in that section). An eligible employer is any taxpayer which employs individuals as miners in underground mines in the United States. No deduction is allowed for the amount of the expenses otherwise deductible which is equal to the amount of the credit.

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

### *Effective Date*

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

## 5. Whistleblower reforms (sec. 406 of the Act and sec. 7623 of the Code)

### *Present Law*

The Code authorizes the IRS to pay such sums as deemed necessary for: "(1) detecting underpayments of tax; and (2) detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving at the same."[1108] Amounts are paid based on a percentage of tax, fines, and penalties (but not interest) actually collected based on the information provided. For specific information that caused the investigation and resulted in recovery, the IRS administratively has set the reward in an amount not to exceed 15 percent of the amounts recovered. For information, although not specific, that nonetheless caused the investigation and was of value in the determination of tax liabilities, the reward is not to exceed 10 percent of the amount recovered. For information that caused the investigation, but had no direct relation-

[1106] Sec. 162(a).
[1107] The credit is part of the general business credit (sec. 38).
[1108] Sec. 7623.

ship to the determination of tax liabilities, the reward is not to exceed one percent of the amount recovered. The reward ceiling is $10 million (for payments made after November 7, 2002), and the reward floor is $100. No reward will be paid if the recovery was so small as to call for payment of less than $100 under the above formulas. Both the ceiling and percentages can be increased with a special agreement. The Code permits the IRS to disclose return information pursuant to a contract for tax administration services.[1109]

### *Explanation of Provision*

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

The provision requires the Secretary to issue guidance within one year of the date of enactment for the operation of a Whistleblower Office within the IRS to administer the reward program. To the extent possible, it is expected that such guidance will address the recommendations of the Treasury Inspector General for Tax Administration regarding the informant's reward program, including the recommendations to centralize management of the reward program and to reduce the processing time for claims.[1110] Under the provision, the Whistleblower Office may seek assistance from the individual providing information or from his or her legal representative, and may reimburse the costs incurred by any legal representative out of the amount of the reward. To the extent the disclosure of returns or return information is required to render such assistance, the disclosure must be pursuant to an IRS tax administration contract. It is expected that such disclosures will be infrequent and will be made only when the assigned task cannot be properly or timely completed without the return information to be disclosed.

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

The provision permits an individual to appeal the amount or a denial of an award determination to the United States Tax Court

[1109] Sec. 6103(n).

[1110] Treasury Inspector General for Tax Administration, The Informants' Rewards Program Needs More Centralized Management Oversight, 2006–30–092 (June 2006).

(the "Tax Court") within 30 days of such determination. Under the provision, Tax Court review of an award determination may be assigned to a special trial judge.

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

### *Effective Date*

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

## 6. Frivolous tax submissions (sec. 407 of the Act and sec. 6702 of the Code)

### *Present Law*

The Code provides that an individual who files a frivolous income tax return is subject to a penalty of $500 imposed by the IRS (sec. 6702). The Code also permits the Tax Court[1111] to impose a penalty of up to $25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

### *Explanation of Provision*

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

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

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

### *Effective Date*

The provision applies to submissions made and issues raised after the date on which the Secretary first prescribes the required list of frivolous positions.

---

[1111] Because in general the Tax Court is the only pre-payment forum available to taxpayers, it deals with most of the frivolous, groundless, or dilatory arguments raised in tax cases.

### 7. Addition of meningococcal and human papillomavirus vaccines to the list of taxable vaccines (sec. 408 of the Act and sec. 4132 of the Code)

#### *Present Law*

A manufacturer's excise tax is imposed at the rate of 75 cents per dose[1112] on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis A, hepatitis B, varicella (chicken pox), rotavirus gastroenteritis, streptococcus pneumoniae and trivalent vaccines against influenza. The tax applied to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a Federal "no fault" insurance system substitute for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

#### *Explanation of Provision*

The provision adds meningococcal vaccines and human papillomavirus vaccines to the list of taxable vaccines.

#### *Effective Date*

The provision is effective for vaccines sold or used on or after the first day of the first month beginning more than four weeks after the date of enactment.

In the case of sales on or before the effective date for which delivery is made after such date, the delivery date shall be considered the sale date.

### 8. Make permanent the tax treatment of certain settlement funds (sec. 409 of the Act and sec. 468B of the Code)

#### *Present Law*

The cleanup of hazardous waste sites is sometimes funded by environmental "settlement funds" or escrow accounts. These escrow accounts are established in consent decrees between the Environmental Protection Agency ("EPA") and the settling parties under the jurisdiction of a Federal district court. The EPA uses these accounts to resolve claims against private parties under Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA").

Present law provides that certain settlement funds established in consent decrees for the sole purpose of resolving claims under

[1112] Sec. 4131.

CERCLA are to be treated as beneficially owned by the United States government and therefore, not subject to Federal income tax.

To qualify the settlement fund must be: (1) established pursuant to a consent decree entered by a judge of a United States District Court; (2) created for the receipt of settlement payments for the sole purpose of resolving claims under CERCLA; (3) controlled (in terms of expenditures of contributions and earnings thereon) by the government or an agency or instrumentality thereof; and (4) upon termination, any remaining funds will be disbursed to such government entity and used in accordance with applicable law. For purposes of the provision, a government entity means the United States, any State of political subdivision thereof, the District of Columbia, any possession of the United States, and any agency or instrumentality of the foregoing.

The provision does not apply to accounts or funds established after December 31, 2010.

### *Explanation of Provision*

The provision permanently extends to funds and accounts established after December 31, 2010, the treatment of certain settlement funds as beneficially owned by the United States government and therefore, not subject to Federal income tax.

### *Effective Date*

The provision is effective as if included in section 201 of the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA").

## 9. Make permanent the active business rules relating to taxation of distributions of stock and securities of a controlled corporation (sec. 410 of the Act and sec. 355 of the Code)

### *Present Law*

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if the corporation had sold such property for its fair market value. In addition, the shareholders receiving the distributed property are ordinarily treated as receiving a dividend of the value of the distribution (to the extent of the distributing corporation's earnings and profits), or capital gain in the case of a stock buyback that significantly reduces the shareholder's interest in the parent corporation.

An exception to these rules applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355 of the Code. If all the requirements are satisfied, there is no tax to the distributing corporation or to the shareholders on the distribution.

One requirement to qualify for tax-free treatment under section 355 is that both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction

during that period (the "active business test").[1113] For this purpose, prior to the enactment of TIPRA, if the distributing or the controlled corporation to which the test was being applied was itself the parent of other subsidiary corporations, the determination whether such parent corporation was considered engaged in the active conduct of a trade or business was made only at that parent corporation level. The test would be satisfied only if (1) that corporation itself was directly engaged in the active conduct of a trade or business, or (2) that corporation was not directly engaged in the active conduct of a trade or business, but substantially all its assets consisted of stock and securities of one or more corporations that it controls that are engaged in the active conduct of a trade or business.[1114] Thus, different tests applied, depending upon whether the corporation being tested itself was engaged in the active conduct of a trade or business, or whether it was a holding company holding stock of other corporations that were engaged in the active conduct of a trade or business.

TIPRA provided that the active trade or business test is always determined by reference to the relevant affiliated group. For the distributing corporation, the relevant affiliated group consists of the distributing corporation as the common parent and all corporations affiliated with the distributing corporation through stock ownership described in section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under section 1504(b)), immediately after the distribution. The relevant affiliated group for a controlled corporation is determined in a similar manner (with the controlled corporation as the common parent).

The provision enacted in TIPRA applies to distributions after the date of enactment (May 17, 2006) and on or before December 31, 2010, with three exceptions. The provision does not apply to distributions (1) made pursuant to an agreement which is binding on the date of enactment and at all times thereafter, (2) described in a ruling request submitted to the IRS on or before the date of enactment, or (3) described on or before the date of enactment in a public announcement or in a filing with the Securities and Exchange Commission. The distributing corporation may irrevocably elect not to have the exceptions described above apply.

The provision also applies, solely for the purpose of determining whether, after the date of enactment, there is continuing qualification under the requirements of section 355(b)(2)(A) of distributions made before such date, as a result of an acquisition, disposition, or

---

[1113] Sec. 355(b). In determining whether a corporation is engaged in an active trade or business that satisfies the requirement, old IRS guidelines for advance ruling purposes required that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least five percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business. Rev. Proc. 2003–3, sec. 4.01(30), 2003–1 I.R.B. 113. More recently, the IRS suspended this specific rule in connection with its general administrative practice of moving IRS resources away from advance rulings on factual aspects of section 355 transactions in general. Rev. Proc. 2003–48, 2003–29 I.R.B. 86.

[1114] Section 355(b)(2)(A). The IRS position has been that the statutory "substantially all" test has required that at least 90 percent of the fair market value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business. Rev. Proc. 96–30, sec. 4.03(5), 1996–1 C.B. 696; Rev. Proc. 77–37, sec. 3.04, 1977–2 C.B. 568.

other restructuring after such date and on or before December 31, 2010.[1115]

### *Explanation of Provision*

The provision deletes the sunset date of December 31, 2010, for all purposes of the provision enacted in TIPRA. Thus, that provision is made permanent.

### *Effective Date*

The provision is effective as if included in section 202 of TIPRA.

## 10. Make permanent the modifications to qualified veterans' mortgage bonds (sec. 411 of the Act and sec. 143 of the Code)

### *Present Law*

Private activity bonds are bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such private person. The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds"). The definition of a qualified private activity bond includes both qualified mortgage bonds and qualified veterans' mortgage bonds.

Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers and purchase price limitations for the home financed with bond proceeds. In addition, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement).

Qualified veterans" mortgage bonds are private activity bonds the proceeds of which are used to make mortgage loans to certain veterans. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984. Qualified veterans' mortgage bonds are not subject to the State volume limitations generally applicable to private activity bonds. Instead, annual issuance in each State is subject to a separate State volume limitation. The five States eligible to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin. Loans financed with qualified veterans' mortgage bonds can be made only with respect to principal residences and can not be made to acquire or replace existing mortgages. Under prior law, mortgage loans made with the proceeds of bonds issued by the five States could be made

[1115] For example, a holding company taxpayer that had distributed a controlled corporation in a spin-off prior to the date of enactment, in which spin-off the taxpayer satisfied the "substantially all" active business stock test of prior law section 355(b)(2)(A) immediately after the distribution, would not be deemed to have failed to satisfy any requirement that it continue that same qualified structure for any period of time after the distribution, solely because of a restructuring that occurred after the date of enactment and before January 1, 2011, and that would satisfy the requirements of new section 355(b)(2)(A).

only to veterans who served on active duty before 1977 and who applied for the financing before the date 30 years after the last date on which such veteran left active service (the "eligibility period"). However, in the case of qualified veterans" mortgage bonds issued by the States of Alaska, Oregon, and Wisconsin, TIPRA repealed the requirement that veterans receiving loans financed with qualified veterans' mortgage bonds must have served before 1977 and reduced the eligibility period to 25 years (rather than 30 years) following release from the military service.

In addition, TIPRA provided new State volume limits for qualified veterans' mortgage bonds issued in the States of Alaska, Oregon and Wisconsin. In 2010, the new annual limit on the total volume of veterans' bonds that can be issued in each of these three States is $25 million. These volume limits are phased-in over the four-year period immediately preceding 2010 by allowing the applicable percentage of the 2010 volume limits. The following table provides those percentages.

| Calendar year: | Applicable percentage is: |
|---|---|
| 2006 | 20 |
| 2007 | 40 |
| 2008 | 60 |
| 2009 | 80 |

The volume limits are zero for 2011 and each year thereafter. Unused allocation cannot be carried forward to subsequent years.

### *Explanation of Provision*

The provision makes permanent TIPRA's changes to the definition of an eligible veteran and the State volume limits for qualified veterans' mortgage bonds issued by the States of Alaska, Oregon, and Wisconsin. The total volume of veterans' bonds that can be issued in each of these three States is $25 million for 2010 and each calendar year thereafter.

### *Effective Date*

The provision is effective as if included in section 203 of TIPRA.

## 11. Make permanent the capital gains treatment for certain self-created musical works (sec. 412 of the Act and sec. 1221 of the Code)

### *Present Law*

#### *Capital gains*

The maximum tax rate on the net capital gain income of an individual is 15 percent for taxable years beginning in 2006. By contrast, the maximum tax rate on an individual's ordinary income is 35 percent. The reduced 15-percent rate generally is available for

gain from the sale or exchange of a capital asset for which the taxpayer has satisfied a holding-period requirement. Capital assets generally include all property held by a taxpayer with certain specified exclusions.

An exclusion from the definition of a capital asset applies to inventory property or property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.[1116] Another exclusion from capital asset status applies to copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property held by a taxpayer whose personal efforts created the property (or held by a taxpayer whose basis in the property is determined by reference to the basis of the taxpayer whose personal efforts created the property).[1117] Under a provision included in TIPRA,[1118] at the election of a taxpayer, the section 1221(a)(1) and (a)(3) exclusions from capital asset status do not apply to musical compositions or copyrights in musical works sold or exchanged before January 1, 2011 by a taxpayer described in section 1221(a)(3).[1119] Thus, if a taxpayer who owns musical compositions or copyrights in musical works that the taxpayer created (or if a taxpayer to which the musical compositions or copyrights have been transferred by the works' creator in a substituted basis transaction) elects the application of this provision, gain from a sale of the compositions or copyrights is treated as capital gain, not ordinary income.

### *Charitable contributions*

A taxpayer generally is allowed a deduction for the fair market value of property contributed to a charity. If a taxpayer makes a contribution of property that would have generated ordinary income (or short-term capital gain), the taxpayer's charitable contribution deduction generally is limited to the property's adjusted basis.[1120] The determination whether property would have generated ordinary income (or short-term capital gain) is made without regard to new section 1221(b)(3) described above.[1121]

## *Explanation of Provision*

The provision makes permanent the availability of the section 1221(b)(3) election to treat certain sales of musical compositions or copyrights in musical works as being sales of capital assets (and therefore as generating capital gain). The provision also makes permanent the accompanying rule limiting to adjusted basis the amount of a charitable contribution deduction allowed for musical compositions or copyrights in musical works to which a taxpayer has elected the application of section 1221(b)(3).

## *Effective Date*

The provision is effective as if included in section 204 of TIPRA.

---

[1116] Sec. 1221(a)(1).
[1117] Sec. 1221(a)(3).
[1118] Pub. L. No. 109–222, sec. 204(a) (2006).
[1119] Sec. 1221(b)(3).
[1120] Sec. 170(e)(1)(A).
[1121] Sec. 170(e)(1)(A), as modified by TIPRA, Pub. L. No. 109–222, sec. 204(b) (2006).

## 12. Make permanent the decrease in minimum vessel tonnage limit to 6,000 deadweight tons (sec. 413 of the Act and sec. 1355 of the Code)

### *Present Law*

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, including income from shipping operations, whether derived in the United States or abroad. In order to mitigate double taxation, a foreign tax credit for income taxes paid to foreign countries is provided to reduce or eliminate the U.S. tax owed on such income, subject to certain limitations.

Generally, the United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income, including income from shipping operations, which is "effectively connected" with the conduct of a trade or business in the United States (sec. 882). Such "effectively connected income" generally is taxed in the same manner and at the same rates as the income of a U.S. corporation.

The United States imposes a four percent tax on the amount of a foreign corporation's U.S. source gross transportation income (sec. 887). Transportation income includes income from the use (or hiring or leasing for use) of a vessel and income from services directly related to the use of a vessel. Fifty percent of the transportation income attributable to transportation that either begins or ends (but not both) in the United States is treated as U.S. source gross transportation income. The tax does not apply, however, to U.S. source gross transportation income that is treated as income effectively connected with the conduct of a U.S. trade or business. U.S. source gross transportation income is not treated as effectively connected income unless (1) the taxpayer has a fixed place of business in the United States involved in earning the income, and (2) substantially all the income is attributable to regularly scheduled transportation.

The tax imposed by section 882 or 887 on income from shipping operations may be limited by an applicable U.S. income tax treaty or by an exemption of a foreign corporation's international shipping operations income in instances where a foreign country grants an equivalent exemption (sec. 883).

Notwithstanding the general rules described above, the American Jobs Creation Act of 2004 ("AJCA")[1122] generally allows corporations that are qualifying vessel operators[1123] to elect a "tonnage tax" in lieu of the corporate income tax on taxable income from certain shipping activities. Accordingly, an electing corporation's gross income does not include its income from qualifying shipping activities (and items of loss, deduction, or credit are disallowed with respect to such excluded income), and electing corporations are only subject to tax on these activities at the maximum corporate income tax rate on their notional shipping income, which is based on the

[1122] Pub. L. No. 108–357, sec. 248. The tonnage tax regime is effective for taxable years beginning after the date of enactment of AJCA (October 22, 2004).

[1123] Generally, a qualifying vessel operator is a corporation that (1) operates one or more qualifying vessels and (2) meets certain requirements with respect to its shipping activities.

net tonnage of the corporation's qualifying vessels.[1124] No deductions are allowed against the notional shipping income of an electing corporation, and no credit is allowed against the notional tax imposed under the tonnage tax regime. In addition, special deferral rules apply to the gain on the sale of a qualifying vessel, if such vessel is replaced during a limited replacement period.

Prior to the enactment of TIPRA,[1125] a "qualifying vessel" was defined as a self-propelled (or a combination of self-propelled and non-self-propelled) United States flag vessel of not less than 10,000 deadweight tons[1126] that is used exclusively in the United States foreign trade. TIPRA expands the definition of "qualifying vessel" to include self-propelled (or a combination of self-propelled and non-self-propelled) United States flag vessels of not less than 6,000 deadweight tons used exclusively in the United States foreign trade. The modified definition of TIPRA applies for taxable years beginning after December 31, 2005 and ending before January 1, 2011.

### *Explanation of Provision*

The provision makes permanent the minimum 6,000 deadweight tons threshold.

### *Effective Date*

The provision is effective as if included in section 205 of TIPRA.

## 13. Make permanent the modification of special arbitrage rule for certain funds (sec. 414 of the Act)

### *Present Law*

In general, present-law tax-exempt bond arbitrage restrictions provide that interest on a State or local government bond is not eligible for tax-exemption if the proceeds are invested, directly or indirectly, in materially higher yielding investments or if the debt service on the bond is secured by or paid from (directly or indirectly) such investments. An exception to the arbitrage restrictions, enacted in 1984, provides that the pledge of income from investments in the Texas Permanent University Fund (the "Fund") as security for a limited amount of tax-exempt bonds will not cause interest on those bonds to be taxable. The terms of this exception are limited to State constitutional or statutory restrictions continuously

---

[1124] An electing corporation's notional shipping income for the taxable year is the product of the following amounts for each of the qualifying vessels it operates: (1) the daily notional shipping income from the operation of the qualifying vessel, and (2) the number of days during the taxable year that the electing corporation operated such vessel as a qualifying vessel in the United States foreign trade. The daily notional shipping income from the operation of a qualifying vessel is (1) 40 cents for each 100 tons of so much of the net tonnage of the vessel as does not exceed 25,000 net tons, and (2) 20 cents for each 100 tons of so much of the net tonnage of the vessel as exceeds 25,000 net tons. "United States foreign trade" means the transportation of goods or passengers between a place in the United States and a foreign place or between foreign places. The temporary use in the United States domestic trade (i.e., the transportation of goods or passengers between places in the United States) of any qualifying vessel or the temporary ceasing to use a qualifying vessel may be disregarded, under special rules.

[1125] Pub. L. No. 109–222, sec. 205 (May 17, 2006).

[1126] Deadweight measures the lifting capacity of a ship expressed in long tons (2,240 lbs.), including cargo, crew, and consumables such as fuel, lube oil, drinking water, and stores. It is the difference between the number of tons of water a vessel displaces without such items on board and the number of tons it displaces when fully loaded.

in effect since October 9, 1969. In addition, the exception only applies to an amount of tax-exempt bonds that does not exceed 20 percent of the value of the Fund.

The Fund consists of certain State lands that were set aside for the benefit of higher education, the income from mineral rights to these lands, and certain other earnings on Fund assets. The Texas constitution directs that monies held in the Fund are to be invested in interest-bearing obligations and other securities. Income from the Fund is apportioned between two university systems operated by the State. Tax-exempt bonds issued by the university systems to finance buildings and other permanent improvements were secured by and payable from the income of the Fund.

Prior to 1999, the constitution did not permit the expenditure or mortgage of the Fund for any purpose. In 1999, the State constitutional rules governing the Fund were modified with regard to the manner in which amounts in the Fund are distributed for the benefit of the two university systems. The State constitutional amendments allow for the possibility that in the event investment earnings are less than annual debt service on the bonds some of the debt service could be considered as having been paid with the Fund corpus. The 1984 exception refers only to bonds secured by investment earnings on securities or obligations held by the Fund. Despite the constitutional amendments, the IRS has agreed to continue to apply the 1984 exception to the Fund through August 31, 2007, if clarifying legislation is introduced in the 109th Congress prior to August 31, 2005. Clarifying legislation was introduced in the 109th Congress on May 26, 2005.[1127]

TIPRA codified and extended the IRS agreement until August 31, 2009. TIPRA conformed the 1984 exception to the State constitutional amendments to permit its continued applicability to bonds of the two university systems. The limitation on the aggregate amount of bonds which may benefit from the exception was not modified, and remains at 20 percent of the value of the Fund.

### *Explanation of Provision*

The provision makes permanent TIPRA's changes to the Fund's arbitrage exception.

### *Effective Date*

The provision is effective as if included in section 206 of TIPRA.

## 14. Great Lakes domestic shipping to not disqualify vessel from tonnage tax (sec. 415 of the Act and sec. 1355 of the Code)

### *Present Law*

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, including income from shipping operations, whether derived in the United States or abroad. In order to mitigate double taxation, a foreign tax credit for income taxes paid to foreign countries is pro-

[1127] H.R. 2661.

vided to reduce or eliminate the U.S. tax owed on such income, subject to certain limitations.

Generally, the United States taxes foreign corporations only on income that has a sufficient nexus to the United States. Thus, a foreign corporation is generally subject to U.S. tax only on income, including income from shipping operations, which is "effectively connected" with the conduct of a trade or business in the United States (sec. 882). Such "effectively connected income" generally is taxed in the same manner and at the same rates as the income of a U.S. corporation.

The United States imposes a four percent tax on the amount of a foreign corporation's U.S. source gross transportation income (sec. 887). Transportation income includes income from the use (or hiring or leasing for use) of a vessel and income from services directly related to the use of a vessel. Fifty percent of the transportation income attributable to transportation that either begins or ends (but not both) in the United States is treated as U.S. source gross transportation income. The tax does not apply, however, to U.S. source gross transportation income that is treated as income effectively connected with the conduct of a U.S. trade or business. U.S. source gross transportation income is not treated as effectively connected income unless (1) the taxpayer has a fixed place of business in the United States involved in earning the income, and (2) substantially all the income is attributable to regularly scheduled transportation.

The tax imposed by section 882 or 887 on income from shipping operations may be limited by an applicable U.S. income tax treaty or by an exemption of a foreign corporation's international shipping operations income in instances where a foreign country grants an equivalent exemption (sec. 883).

Notwithstanding the general rules described above, the American Jobs Creation Act of 2004 ("AJCA")[1128] generally allows corporations that are qualifying vessel operators[1129] to elect a "tonnage tax" in lieu of the corporate income tax on taxable income from certain shipping activities. Accordingly, an electing corporation's gross income does not include its income from qualifying shipping activities (and items of loss, deduction, and credit are disallowed with respect to such excluded income),[1130] and electing corporations are only subject to tax on these activities at the maximum corporate income tax rate on their notional shipping income, which is based on the net tonnage of the corporation's qualifying vessels operated in the United States foreign trade.[1131] "United States foreign trade" means the transportation of goods or passengers between a place in the United States and a foreign place or between foreign

[1128] Pub. L. No. 108–357, sec. 248. The tonnage tax regime is effective for taxable years beginning after the date of enactment of AJCA (October 22, 2004).

[1129] Generally, a qualifying vessel operator is a corporation that (1) operates one or more qualifying vessels and (2) meets certain requirements with respect to its shipping activities.

[1130] Sec. 1357.

[1131] An electing corporation's notional shipping income for the taxable year is the product of the following amounts for each of the qualifying vessels it operates: (1) the daily notional shipping income from the operation of the qualifying vessel, and (2) the number of days during the taxable year that the electing corporation operated such vessel as a qualifying vessel in the United States foreign trade. The daily notional shipping income from the operation of a qualifying vessel is (1) 40 cents for each 100 tons of so much of the net tonnage of the vessel as does not exceed 25,000 net tons, and (2) 20 cents for each 100 tons of so much of the net tonnage of the vessel as exceeds 25,000 net tons.

places. No deductions are allowed against the notional shipping income of an electing corporation, and no credit is allowed against the notional tax imposed under the tonnage tax regime. In addition, special deferral rules apply to the gain on the sale of a qualifying vessel, if such vessel is replaced during a limited replacement period.

A "qualifying vessel" is defined as a self-propelled (or a combination of self-propelled and non-self-propelled) United States flag vessel of not less than 6,000 deadweight tons[1132] that is used exclusively in the United States foreign trade. Notwithstanding the "exclusively in the United States foreign trade" requirement, the temporary use of any qualifying vessel in the United States domestic trade (i.e., the transportation of goods or passengers between places in the United States) may be disregarded, and treated as the continued use of such vessel in the United States foreign trade, if the electing corporation provides timely notice of such temporary use to the Secretary. However, if a qualifying vessel is operated in the United States domestic trade for more than 30 days during the taxable year, then no usage in the United States domestic trade during such year may be disregarded (and the vessel is thereby disqualified). The Secretary has the authority to prescribe regulations as may be necessary or appropriate to carry out the purposes of the statutory rules relating to the temporary domestic use of vessels.[1133]

### *Explanation of Provision*

Under the provision, a corporation for which a tonnage tax election is in effect ("electing corporation") may make a further election with respect to a qualifying vessel used during a taxable year in "qualified zone domestic trade." The term "qualified zone domestic trade" means the transportation of goods or passengers between places in the "qualified zone" if such transportation is in the United States domestic trade. The transportation of goods or passengers between a U.S. port in the qualified zone and a U.S. port outside the qualified zone (in either direction) is United States domestic trade that is not qualified zone domestic trade.

The term "qualified zone" means the Great Lakes Waterway and the St. Lawrence Seaway. This area consists of the deep-draft waterways of Lake Superior, Lake Michigan, Lake Huron (including Lake St. Clair), Lake Eire, and Lake Ontario, connecting deep-draft channels, including the Detroit River, the St. Clair River, the St. Marys River, and the Welland Canal, and the waterway between the port of Sept-Iles, Quebec and Lake Ontario, including all locks, canals, and connecting and contiguous waters that are part of these deep-draft waterways.

Activities in qualified zone domestic trade are not qualifying shipping activities and, therefore, do not qualify for the tonnage tax regime. In the case of a qualifying vessel for which an election

---

[1132] Prior to the enactment on May 17, 2006 of Pub. L. No. 109–222, TIPRA, "qualifying vessel" meant a self-propelled (or a combination of self-propelled and non-self-propelled) United States flag vessel of not less than 10,000 deadweight tons used exclusively in the United States foreign trade. TIPRA changed the threshold to 6,000 deadweight tons, effective for taxable years beginning after December 31, 2005 and ending before January 1, 2011. Section 413 of this Act permanently extends the 6,000 deadweight tons threshold.

[1133] Sec. 1355(g).

under this provision ("qualified zone domestic trade election") is in force, the Secretary is to prescribe rules for the proper allocation of income, expenses, losses, and deductions between the qualified shipping activities and the other activities of such vessel. These rules may include intra-vessel allocation rules that are different than the rules pertaining to allocations of items between qualifying vessels and other vessels.

An electing corporation making a qualified zone domestic trade election with respect to a vessel is not required to give notice to the Secretary of the use of such vessel in qualified zone domestic trade, and an otherwise qualifying vessel does not cease to be a qualifying vessel solely due to such use when such election is in effect, even if such use exceeds 30 days during the taxable year. An electing corporation making a qualified zone domestic trade election with respect to a vessel is treated as using such vessel in qualified zone domestic trade during any period of temporary use in the United States domestic trade (other than qualified zone domestic trade) if such electing corporation gives timely notice to the Secretary stating that it temporarily operates or has operated in the United States domestic trade (other than qualified zone domestic trade) a qualifying vessel which had been used in the United States foreign trade or qualified zone domestic trade, and that it intends to resume operating such vessel in the United States foreign trade or qualified zone domestic trade. The period of such permissible temporary use of such vessel in such United States domestic trade continues until the earlier of the date on which the electing corporation abandons its intention to resume operation of the vessel in the United States foreign trade or qualified zone domestic trade, or the electing corporation resumes operation of the vessel in the United States foreign trade or qualified zone domestic trade. However, if a qualifying vessel is operated in the United States domestic trade (other than qualified zone domestic trade) for more than 30 days during the taxable year, then no usage in the United States domestic trade (other than qualified zone domestic trade) during such year may be disregarded (and the vessel is thereby disqualified). Thus, a vessel used for 120 days in the taxable year in qualified zone domestic trade and 180 days in the taxable year in the United States foreign trade is not a qualifying vessel if it is used for over 30 days in the taxable year in the United States domestic trade that is not qualified zone domestic trade.

Under the provision, the Secretary may specify the time, manner and other conditions for making, maintaining, and terminating the qualified zone domestic trade election.

### *Effective Date*

The provision is effective for taxable years beginning after date of enactment.

## 15. Expansion of the qualified mortgage bond program (sec. 416 of the Act and sec. 143 of the Code)

### *Present Law*

Private activity bonds are bonds that nominally are issued by States or local governments, but the proceeds of which are used (di-

rectly or indirectly) by a private person and payment of which is derived from funds of such private person. The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds"). The definition of a qualified private activity bond includes both qualified mortgage bonds and qualified veterans' mortgage bonds.

Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers and purchase price limitations for the home financed with bond proceeds. In addition, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement).

Qualified veterans' mortgage bonds are private activity bonds the proceeds of which are used to make mortgage loans to certain veterans. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984. Qualified veterans' mortgage bonds are not subject to the State volume limitations generally applicable to private activity bonds. Instead, annual issuance in each State is subject to a separate State volume limitation. The five States eligible to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin. Loans financed with qualified veterans' mortgage bonds can be made only with respect to principal residences and can not be made to acquire or replace existing mortgages. Under prior law, mortgage loans made with the proceeds of bonds issued by the five States could be made only to veterans who served on active duty before 1977 and who applied for the financing before the date 30 years after the last date on which such veteran left active service (the "eligibility period"). However, in the case of qualified veterans' mortgage bonds issued by the States of Alaska, Oregon, and Wisconsin, TIPRA repealed the requirement that veterans receiving loans financed with qualified veterans' mortgage bonds must have served before 1977 and reduced the eligibility period to 25 years (rather than 30 years) following release from the military service. In addition, TIPRA provided new State volume limits for qualified veterans' mortgage bonds issued in the States of Alaska, Oregon and Wisconsin, phased-in over a four- year period.

### *Explanation of Provision*

Under the provision, qualified mortgage bonds may be issued to finance mortgages for veterans who served in the active military without regard to the first-time homebuyer requirement. Present-law income and purchase price limitations apply to loans to veterans financed with the proceeds of qualified mortgage bonds. Veterans are eligible for the exception from the first-time homebuyer requirement without regard to the date they last served on active duty or the date they applied for a loan after leaving active duty. However, veterans may only use the exception one time.

### *Effective Date*

The provision applies to bonds issued after the date of enactment and before January 1, 2008.

## 16. Exclusion of gain on sale of a principal residence by certain employees of the intelligence community (sec. 417 of the Act and sec. 121 of the Code)

### *Present Law*

Under present law, an individual taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met.

Present law also contains special rules relating to members of the uniformed services or the Foreign Service of the United States. An individual may elect to suspend for a maximum of 10 years the five-year test period for ownership and use during certain absences due to service in the uniformed services or the Foreign Service of the United States. The uniformed services include: (1) the Armed Forces (the Army, Navy, Air Force, Marine Corps, and Coast Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to 10 years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty as a member of the uniformed services or in the Foreign Service of the United States. For these purposes, qualified official extended duty is any period of extended duty while serving at a place of duty at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in government furnished quarters. Extended duty is defined as any period of duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. The election may be made with respect to only one property for a suspension period.

### *Explanation of Provision*

Under the provision, specified employees of the intelligence community may elect to suspend the running of the five-year test period during any period in which they are serving on extended duty. The term "employee of the intelligence community" means an employee of the Office of the Director of National Intelligence, the Central Intelligence Agency, the National Security Agency, the Defense Intelligence Agency, the National Geospatial-Intelligence Agency, or the National Reconnaissance Office. The term also in-

cludes employment with: (1) any other office within the Department of Defense for the collection of specialized national intelligence through reconnaissance programs; (2) any of the intelligence elements of the Army, the Navy, the Air Force, the Marine Corps, the Federal Bureau of Investigation, the Department of the Treasury, the Department of Energy, and the Coast Guard; (3) the Bureau of Intelligence and Research of the Department of State; and (4) the elements of the Department of Homeland Security concerned with the analyses of foreign intelligence information. To qualify, a specified employee must move from one duty station to another and the new duty station must be located outside of the United States. As under present law, the five-year period may not be extended more than 10 years.

### *Effective Date*

The provision is effective for sales and exchanges after the date of enactment and before January 1, 2011.

## 17. Sale of property to comply with conflict-of-interest requirements (sec. 418 of the Act and sec. 1043 of the Code)

### *Present Law*

Present law provides special rules for deferring the recognition of gain on sales of property which are required in order to comply with certain conflict of interest requirements imposed by the Federal government. Certain executive branch Federal employees (and their spouses and minor or dependent children) who are required to divest property in order to comply with conflict of interest requirements may elect to postpone the recognition of resulting gains by investing in certain replacement property within a 60-day period. The basis of the replacement property is reduced by the amount of the gain not recognized. Permitted replacement property is limited to any obligation of the United States or any diversified investment fund approved by regulations issued by the Office of Government Ethics. The rule applies only to sales under certificates of divestiture issued by the President or the Director of the Office of Government Ethics.

### *Explanation of Provision*

The provision extends the provision deferring recognition of gain to a judicial officer who receives a certificate of divestiture from the Judicial Conference of the United States (or its designee) regarding the divestiture of certain property reasonably necessary to comply with conflict of interest rules or the judicial canon. For purposes of this provision, a judicial officer means the Chief Justice of the United States, the Associate Justices of the Supreme Court, and the judges of the United States courts of appeals, United States district courts, including the district courts in Guam, the Northern Mariana Islands, and the Virgin Islands, Court of Appeals for the Federal Circuit, Court of International Trade, Tax Court, Court of Federal Claims, Court of Appeals for Veterans Claims, United States Court of Appeals for the Armed Forces, and any court cre-

ated by Act of Congress, the judges of which are entitled to hold office during good behavior.

### *Effective Date*

The provision applies to sales after the date of enactment.

## 18. Establish deduction for private mortgage insurance (sec. 419 of the Act and sec. 163 of the Code)

### *Present Law*

Present law provides that qualified residence interest is deductible notwithstanding the general rule that personal interest is nondeductible (sec. 163(h)).

Qualified residence interest is interest on acquisition indebtedness and home equity indebtedness with respect to a principal and a second residence of the taxpayer. The maximum amount of home equity indebtedness is $100,000. The maximum amount of acquisition indebtedness is $1 million. Acquisition indebtedness means debt that is incurred in acquiring constructing, or substantially improving a qualified residence of the taxpayer, and that is secured by the residence. Home equity indebtedness is debt (other than acquisition indebtedness) that is secured by the taxpayer's principal or second residence, to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.

### *Explanation of Provision*

The provision provides that premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness on a qualified residence of the taxpayer are treated as interest that is qualified residence interest and thus deductible. The amount allowable as a deduction under the provision is phased out ratably by 10 percent for each $1,000 by which the taxpayer's adjusted gross income exceeds $100,000 ($500 and $50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer's adjusted gross income exceeds $109,000 ($54,500 in the case of married individual filing a separate return).

For this purpose, qualified mortgage insurance means mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, or the Rural Housing Administration, and private mortgage insurance (defined in section 2 of the Homeowners Protection Act of 1998 as in effect on the date of enactment of the provision).

Amounts paid for qualified mortgage insurance that are properly allocable to periods after the close of the taxable year are treated as paid in the period to which they are allocated. No deduction is allowed for the unamortized balance if the mortgage is paid before its term (except in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Administration).

The provision does not apply with respect to any mortgage insurance contract issued before January 1, 2007. The provision terminates for any amount paid or accrued after December 31, 2007, or properly allocable to any period after that date.

Reporting rules apply under the provision.

### *Effective Date*

The provision is effective for amounts paid or accrued after December 31, 2006.

## 19. Modification of refunds for kerosene used in aviation (sec. 420 of the Act and sec. 6427 of the Code)

### *Present Law*

#### *Nontaxable uses of kerosene*

In general, if kerosene on which tax has been imposed is used by any person for a nontaxable use, a refund in an amount equal to the amount of tax imposed may be obtained either by the purchaser, or in specific cases, the registered ultimate vendor of the kerosene.[1134] However, the 0.1 cent per gallon representing the Leaking Underground Storage Tank Trust Fund financing rate generally is not refundable, except for exports.[1135]

A nontaxable use is any use which is exempt from the tax imposed by section 4041(a)(1) other than by reason of a prior imposition of tax.[1136] Nontaxable uses of kerosene include:

- Use on a farm for farming purposes;[1137]
- Use in foreign trade or trade between the United States and any of its possessions;[1138]
- Use as a fuel in vessels and aircraft owned by the United States or any foreign nation and constituting equipment of the armed forces thereof;[1139]
- Exclusive use of a state or local government;[1140]
- Export or shipment to a possession of the United States;[1141]
- Exclusive use of a nonprofit educational organization;[1142]
- Use as a fuel in an aircraft museum for the procurement, care, or exhibition of aircraft of the type used for combat or transport in World War II;[1143] and
- Use as a fuel in (a) helicopters engaged in the exploration for or the development or removal of hard minerals, oil, or gas and in timber (including logging) operations if the helicopters neither take off from nor land at a facility eligible for Airport Trust Fund assistance or otherwise use federal aviation services during flights or (b) any air transportation for the purpose of providing emergency medical services (1) by helicopter or (2)

---

[1134] Sec. 6427(l).
[1135] Sec. 6430.
[1136] Sec. 6427(l)(2).
[1137] Sec. 4041(f).
[1138] Sec. 4041(g)(1).
[1139] *Id.*
[1140] Sec. 4041(g)(2).
[1141] Sec. 4041(g)(3).
[1142] Sec. 4041(g)(4).
[1143] Sec. 4041(h).

by a fixed-wing aircraft equipped for and exclusively dedicated on that flight to acute care emergency medical services.[1144]

- Off-highway business use.

Since 4041(a) is limited to the delivery into the fuel supply tank of a diesel-powered highway vehicle or train, kerosene delivered into the fuel supply tank of aircraft is a nontaxable use for purposes of section 4041(a).

### *Claims for refund of kerosene used in aviation*

"Commercial aviation" is the use of an aircraft in a business of transporting persons or property for compensation or hire by air, with certain exceptions.[1145] All other aviation is noncommercial aviation.

For fuel not removed directly into the wing of an airplane, the Safe, Accountable, Flexible, Efficient, Transportation Equity Act: A Legacy for Users ("SAFETEA") changed the rate of taxation for aviation-grade kerosene from 21.8 cents per gallon to the general kerosene and diesel rate of 24.3 cents per gallon.[1146] In order to preserve the aviation rate for fuel actually used in aviation, the 21.8 cent rate of taxation (or as the case may be, the 4.3 cent commercial aviation rate, or the nontaxable use rate) is achieved through a refund when the fuel is used in aviation (a refund of 2.5 cents for taxable noncommercial aviation, 20 cents in the case of commercial aviation, and 24.3 cents for nontaxable uses).[1147] These changes became effective on October 1, 2005.

Prior to October 1, 2005, if fuel that was previously taxed was used in noncommercial aviation for a nontaxable use, generally, the ultimate purchaser of such fuel (other than for the exclusive use of a State or local government, or for use on a farm for farming purposes) could claim a refund for the tax that was paid. SAFETEA eliminated the ability of a purchaser to file for a refund with respect to fuel used in noncommercial aviation. Instead, the registered ultimate vendor is the exclusive party entitled to a refund with respect to kerosene used in noncommercial aviation.[1148] An ultimate vendor is the person who sells the kerosene to an ultimate purchaser for use in noncommercial aviation. If the fuel was used for a nontaxable use, the vendor may make a claim for 24.3 cents per gallon, otherwise, the vendor is permitted to claim 2.5 cents per gallon for kerosene sold for use in noncommercial aviation.[1149]

For commercial aviation, the ultimate purchaser has the option of filing a claim itself, or waiving the right to refund to its ultimate vendor, if the vendor agrees to file on behalf of the purchaser.[1150]

---

[1144] Secs. 4041(l), 4261(f) and (g).

[1145] "Commercial aviation" does not include aircraft used for skydiving, small aircraft on non-established lines or transportation for affiliated group members.

[1146] Sec. 11161 of Pub. L. No. 109–59 (2005).

[1147] Sec. 6427(l)(1), (4) and (5).

[1148] Sec. 6427(l)(5)(B).

[1149] Sec. 6427(l)(5)(A). Under this provision, of the 24.4 cents of tax imposed on kerosene used in taxable noncommercial aviation, the 0.1 cent for the Leaking Underground Storage Tank Trust Fund financing rate and 21.8 cents of the tax imposed on kerosene cannot be refunded. The limitations of sec. 6427(l)(5)(A) on the amount that cannot be refunded do not apply to uses exempt from tax. However, sec. 6430 prevents a refund of the Leaking Underground Storage Tank Trust Fund financing rate in all cases except export. Sec. 6427(l)(5)(B) requires that all amounts that would have been paid to the ultimate purchaser pursuant to sec. 6427(l)(1) are to be paid to the ultimate registered vendor, therefore the ultimate registered vendor is the only claimant for both nontaxable and taxable use of kerosene in noncommercial aviation.

[1150] Sec. 6427(l)(4)(B).

A separate special rule also applies to kerosene sold to a State or local government, regardless of whether the kerosene was sold for aviation or other purposes.[1151] In general, this rule makes the registered ultimate vendor the appropriate party for filing refund claims on behalf of a State or local government. Special rules apply for credit card sales.[1152]

### *Explanation of Provision*

#### *In general*

The provision allows purchasers that use kerosene for an exempt aviation purpose (other than in the case of a State or local government) to make a claim for refund of the tax that was paid on such fuel or waive their right to claim a refund to their registered ultimate vendors. As a result, under the provision, crop-dusters, air ambulances, aircraft engaged in foreign trade and other exempt users may either make the claim for refund of the 24.3 cents per gallon themselves or waive the right to their vendors.

General noncommercial aviation use (which is entitled to a refund of 2.5 cents-per-gallon) remains an exclusive ultimate vendor rule. The rules for State and local governments also are unchanged.

#### *Special rule for purchases of kerosene used in aviation on a farm for farming purposes*

For kerosene used in aviation on a farm for farming purposes that was purchased after December 31, 2004, and before October 1, 2005, the Secretary is to pay to the ultimate purchaser (without interest) an amount equal to the aggregate amount of tax imposed on such fuel, reduced by any payments made to the ultimate vendor of such fuel. Such claims must be filed within 3 months of the date of enactment and may not duplicate claims filed under section 6427(l).

### *Effective Date*

In general, the provision is effective for kerosene sold after September 30, 2005. For kerosene used for an exempt aviation purpose eligible for the waiver rule created by the provision, the ultimate purchaser is treated as having waived the right to payment and as having assigned such right to the ultimate vendor if the vendor meets the requirements of subparagraph (A), (B) or (D) of section 6416(a)(1). The rule of the preceding sentence applies to kerosene sold after September 30, 2005, and before the date of enactment.

The special rule for kerosene used in aviation on a farm for farming purposes is effective on the date of enactment.

---

[1151] Sec. 6427(l)(6).

[1152] If certain conditions are met, a registered credit card issuer may make the claim for refund in place of the ultimate vendor. If the diesel fuel or kerosene is purchased with a credit card issued to a State but the credit card issuer is not registered with the IRS (or does not meet certain other conditions) the credit card issuer must collect the amount of the tax and the State is the proper claimant.

## 20. Regional income tax agencies treated as States for purposes of confidentiality and disclosure requirements (sec. 421 of the Act and sec. 6103 of the Code)

### *Present Law*

Generally, tax returns and return information ("tax information") is confidential and may not be disclosed unless authorized in the Code. One exception to the general rule of confidentiality is the disclosure of the tax information to States.

Tax information with respect to certain taxes is open to inspection by State agencies, bodies, commissions, or its legal representatives, charged under the laws of the State with tax administration responsibilities.[1153] Such inspection is permitted only to the extent necessary for State tax administration proposes. The Code requires a written request from the head of the agency, body or commission as a prerequisite for disclosure. State officials who receive this information may redisclose it to the agency's contractors but only for State tax administration purposes.[1154]

The term "State" includes the 50 States, the District of Columbia, and certain territories.[1155] In addition, cities with populations in excess of 250,000 that impose a tax or income or wages and with which the IRS is entered into an agreement regarding disclosure also are treated as States.[1156]

### *Explanation of Provision*

The provision broadens the definition of "State" to include a regional income tax agency administering the tax laws of municipalities which have a collective population in excess of 250,000. Specifically, under the provision, the term "State" includes any governmental entity (1) that is formed and operated by a qualified group of municipalities, and (2) with which the Secretary (in his sole discretion) has entered into an agreement regarding disclosure. The term "qualified group of municipalities" means, with respect to any governmental entity, two or more municipalities: (1) each of which imposes a tax on income or wages, (2) each of which, under the authority of a State statute, administers the laws relating to the imposition of such taxes through such entity, and (3) which collectively have a population in excess of 250,000 (as determined under the most recent decennial United States census data available).

The regional income tax agency is treated as a State for purposes of applying the confidentiality and disclosure provisions for State tax officials, determining the scope of tax administration, applying the rules governing disclosures in judicial and administrative tax proceedings, and applying the safeguard procedures. Because a regional income tax agency administers the laws of its member municipalities, the provision provides that references to State law, State proceedings or State tax returns should be treated as references to the law, proceedings or tax returns of the municipalities which form and operate the regional income tax agency.

---

[1153] Sec. 6103(d)(1).
[1154] Sec. 6103(n).
[1155] Sec. 6103(b)(5)(A).
[1156] Sec. 6103(b)(5)(B).

Inspection by or disclosure to an entity described above shall be only for the purpose of and to the extent necessary in the administration of the tax laws of the member municipalities in such entity relating to the imposition of a tax on income or wages. Such entity may not redisclose tax information to its member municipalities. This rule does not preclude the entity from disclosing data in a form which cannot be associated with or otherwise identify directly or indirectly a particular taxpayer.[1157]

The provision requires that a regional income tax agency conduct on-site reviews every three years of all of its contractors or other agents receiving Federal returns and return information. If the duration of the contract or agreement is less than three years, a review is required at the mid-point of the contract. The purpose of the review is to assess the contractor's efforts to safeguard Federal tax information. This review is intended to cover secure storage, restricting access, computer security, and other safeguards deemed appropriate by the Secretary. Under the provision, the regional income tax agency is required to submit a report of its findings to the IRS and certify annually that such contractors and other agents are in compliance with the requirements to safeguard the confidentiality of Federal tax information. The certification is required to include the name and address of each contractor or other agent with the agency, the duration of the contract, and a description of the contract or agreement with the regional income tax agency.

This provision does not alter or affect in any way the right of the IRS to conduct safeguard reviews of regional income tax agency contractors or other agents. It also does not affect the right of the IRS to approve initially the safeguard language in the contract or agreement and the safeguards in place prior to any disclosures made in connection with such contracts or agreements.

### *Effective Date*

The provision is effective for disclosures made after December 31, 2006.

## 21. Semi-generic wine names (sec. 422 of the Act and sec. 5388 of the Code)

### *Present Law*

The Code contains certain provisions with respect to wine relating to consumer protection and trade. Section 5388(c) allows a semi-generic wine name to be used to designate wine of an origin other than that indicated by its name only if the label discloses the place of origin and the wine conforms to the standard of identity contained in regulations (or, if there is no such standard, to the trade understanding of such class or type). The Code specifies that the following names shall be treated as semi-generic: Angelica, Burgundy, Claret, Chablis, Champagne, Chianti, Malaga, Marsala, Madeira, Moselle, Port, Rhine Wine or Hock, Sauterne, Haut Sauterne, Sherry, and Tokay. Other names of geographic significance,

[1157] By definition "return information" does not include data in a form which cannot be associated with or otherwise identify directly or indirectly a particular taxpayer (sec. 6103(b)(2)).

which are also designations of a class and type of wine, shall be deemed to have become semi-generic only if so found by the Secretary of the Treasury.[1158]

On March 10, 2006, the United States signed the Agreement between the United States of America and the European Community on Trade in Wine (the "Agreement") under which, among other things, the United States entered into certain obligations with respect to certain semi-generic wine names of European origin.

### *Explanation of Provision*

The provision implements the obligations of the United States under the Agreement with respect to certain semi-generic wine names of European origin.

Accordingly, the provision amends section 5388(c) to limit the use of semi-generic names specified in the Code to wine originating in the European Community ("EC") and to certain non-EC wine. EC wine may bear a specified semi-generic name if the wine so designated conforms to the standard of identity contained in regulations (or, if there is no such standard, to the trade understanding of such class or type). Non-EC wine that bears a brand name, or a brand name and fanciful name, may bear a specified semi-generic name only if: (1) the label discloses the place of origin; (2) the wine conforms to the standard of identity contained in regulations (or, if there is no such standard, to the trade understanding of such class or type); and (3) the person or its successor in interest held a Certificate of Label Approval or a Certificate of Exemption from Label Approval for a wine label bearing such brand name prior to March 10, 2006, on which such semi-generic designation appeared.

In addition, the provision adds Retsina to the statutory list of names treated as semi-generic for the purposes of these new rules and does not include Angelica on such list.

The provision does not apply to wine that (1) contains less than seven percent or more than 24 percent alcohol by volume; (2) does not bear a brand name; or (3) is intended for sale outside the United States. Such wine continues to be governed by present law.

### *Effective Date*

The provision applies to wine imported or bottled in the United States on or after the date of enactment.

## 22. Railroad track maintenance credit (sec. 423 of the Act and sec. 45G of the Code)

### *Present Law*

Present law provides a 50-percent business tax credit for qualified railroad track maintenance expenditures paid or incurred by an eligible taxpayer during the taxable year. The credit is limited to the product of $3,500 times the number of miles of railroad track (1) owned or leased by an eligible taxpayer as of the close of its taxable year, and (2) assigned to the eligible taxpayer by a Class II or Class III railroad that owns or leases such track at the close of

[1158] See 27 C.F.R. sec. 4.24(b).

the taxable year. Each mile of railroad track may be taken into account only once, either by the owner of such mile or by the owner's assignee, in computing the per-mile limitation. Under the provision, the credit is limited in respect of the total number of miles of track (1) owned or leased by the Class II or Class III railroad and (2) assigned to the Class II or Class III railroad for purposes of the credit.

Qualified railroad track maintenance expenditures are defined as expenditures (whether or not otherwise chargeable to capital account) for maintaining railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class II or Class III railroad.

An eligible taxpayer means any Class II or Class III railroad, and any person who transports property using the rail facilities of a Class II or Class III railroad or who furnishes railroad-related property or services to a Class II or Class III railroad, but only with respect to miles of railroad track assigned to such person by such railroad under the provision.

The terms Class II or Class III railroad have the meanings given by the Surface Transportation Board.

The provision applies to qualified railroad track maintenance expenditures paid or incurred during taxable years beginning after December 31, 2004, and before January 1, 2008.

### *Explanation of Provision*

The provision modifies the definition of qualified railroad track expenditures, so that the term means gross expenditures (whether or not otherwise chargeable to capital account) for maintaining railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class II or Class III railroad (determined without regard to any consideration for such expenditures given by the Class II or Class III railroad which made the assignment of such track).

Thus, for example, under the provision, qualified railroad track maintenance expenditures are not reduced by the discount amount in the case of discounted freight shipping rates, the increment in a markup of the price for track materials, or by debt forgiveness or by cash payments made by the Class II or Class III railroad to the assignee as consideration for the expenditures. Consideration received directly or indirectly from persons other that the Class II or Class III railroad, however, does reduce the amount of qualified railroad track maintenance expenditures. No inference is intended under the provision as to whether or not any such consideration is or is not includable in the assignee's income for Federal tax purposes.

### *Effective Date*

The provision is effective for expenditures paid or incurred during taxable years beginning after December 31, 2004, and before January 1, 2008.

## 23. Modify tax on unrelated business taxable income of charitable remainder trusts (sec. 424 of the Act and sec. 664 of the Code)

### *Present Law*

A charitable remainder annuity trust is a trust that is required to pay, at least annually, a fixed dollar amount of at least five percent of the initial value of the trust to a noncharity for the life of an individual or for a period of 20 years or less, with the remainder passing to charity. A charitable remainder unitrust is a trust that generally is required to pay, at least annually, a fixed percentage of at least five percent of the fair market value of the trust's assets determined at least annually to a noncharity for the life of an individual or for a period 20 years or less, with the remainder passing to charity.[1159]

A trust does not qualify as a charitable remainder annuity trust if the annuity for a year is greater than 50 percent of the initial fair market value of the trust's assets. A trust does not qualify as a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50 percent. A trust does not qualify as a charitable remainder annuity trust or a charitable remainder unitrust unless the value of the remainder interest in the trust is at least 10 percent of the value of the assets contributed to the trust.

Distributions from a charitable remainder annuity trust or charitable remainder unitrust are treated in the following order as: (1) ordinary income to the extent of the trust's undistributed ordinary income for that year and all prior years; (2) capital gains to the extent of the trust's undistributed capital gain for that year and all prior years; (3) other income (e.g., tax-exempt income) to the extent of the trust's undistributed other income for that year and all prior years; and (4) corpus.[1160]

In general, distributions to the extent they are characterized as income are includible in the income of the beneficiary for the year that the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the trust's taxable year.[1161]

Charitable remainder annuity trusts and charitable remainder unitrusts are exempt from Federal income tax for a tax year unless the trust has any unrelated business taxable income for the year. Unrelated business taxable income includes certain debt financed income. A charitable remainder trust that loses exemption from income tax for a taxable year is taxed as a regular complex trust. As such, the trust is allowed a deduction in computing taxable income for amounts required to be distributed in a taxable year, not to exceed the amount of the trust's distributable net income for the year.

---

[1159] Sec. 664(d).
[1160] Sec. 664(b).
[1161] Treas. Reg. sec. 1.664–1(d)(4).

### *Explanation of Provision*

The provision imposes a 100-percent excise tax on the unrelated business taxable income of a charitable remainder trust. This replaces the present-law rule that takes away the income tax exemption of a charitable remainder trust for any year in which the trust has any unrelated business taxable income. Consistent with present law, the tax is treated as paid from corpus. The unrelated business taxable income is considered income of the trust for purposes of determining the character of the distribution made to the beneficiary.

### *Effective Date*

The provision is effective for taxable years beginning after December 31, 2006.

## 24. Make permanent the special rule regarding treatment of loans to qualified continuing care facilities (sec. 425 of the Act and sec. 7872(h) of the Code)

### *Present Law*

#### *In general*

Present law provides generally that certain loans that bear interest at a below-market rate are treated as loans bearing interest at the market rate, accompanied by imputed payments characterized in accordance with the substance of the transaction (for example, as a gift, compensation, a dividend, or interest).[1162]

For calendar years beginning before January 1, 2006, an exception to this imputation rule is provided for any calendar year for a below-market loan made by a lender to a qualified continuing care facility pursuant to a continuing care contract, if the lender or the lender's spouse attains age 65 before the close of the calendar year.[1163]

The exception applies only to the extent the aggregate outstanding loans by the lender (and spouse) to any qualified continuing care facility do not exceed $163,300 (for 2006).[1164]

For this purpose, a continuing care contract means a written contract between an individual and a qualified continuing care facility under which: (1) the individual or the individual's spouse may use a qualified continuing care facility for the life or lives of one or both individuals; (2) the individual or the individual's spouse will first reside in a separate, independent living unit with additional facilities outside such unit for the providing of meals and other personal care and will not require long-term nursing care, and then will be provided long-term and skilled nursing care as the health of the individual or the individual's spouse requires; and (3) no additional substantial payment is required if the individual or the individual's spouse requires increased personal care services or long-term and skilled nursing care.[1165]

---

[1162] Sec. 7872.
[1163] Sec. 7872(g).
[1164] Rev. Rul. 2005–75, 2005–49 I.R.B. 1073.
[1165] Sec. 7872(g)(3).

For this purpose, a qualified continuing care facility means one or more facilities that are designed to provide services under continuing care contracts, and substantially all of the residents of which are covered by continuing care contracts. A facility is not treated as a qualified continuing care facility unless substantially all facilities that are used to provide services required to be provided under a continuing care contract are owned or operated by the borrower. For these purposes, a nursing home is not a qualified continuing care facility.[1166]

### *Special rule for calendar years beginning after 2005 and before 2011*

TIPRA includes a provision modifying the exception under section 7872 relating to loans to continuing care facilities. Among other things, the modification eliminates the dollar cap on aggregate outstanding loans.[1167]

Under the TIPRA provision, a continuing care contract is a written contract between an individual and a qualified continuing care facility under which: (1) the individual or the individual's spouse may use a qualified continuing care facility for the life or lives of one or both individuals; (2) the individual or the individual's spouse will be provided with housing, as appropriate for the health of such individual or individual's spouse, (i) in an independent living unit (which has additional available facilities outside such unit for the provision of meals and other personal care), and (ii) in an assisted living facility or a nursing facility, as is available in the continuing care facility; and (3) the individual or the individual's spouse will be provided assisted living or nursing care as the health of the individual or the individual's spouse requires, and as is available in the continuing care facility. The Secretary is required to issue guidance that limits the term "continuing care contract" to contracts that provide only facilities, care, and services described in the preceding sentence.[1168]

For purposes of defining the terms "continuing care contract" and "qualified continuing care facility," the term "assisted living facility" is intended to mean a facility at which assistance is provided (1) with activities of daily living (such as eating, toileting, transferring, bathing, dressing, and continence) or (2) in cases of cognitive impairment, to protect the health or safety of an individual. The term "nursing facility" is intended to mean a facility that offers care requiring the utilization of licensed nursing staff.

The TIPRA modifications generally are effective for calendar years beginning after December 31, 2005, with respect to loans made before, on, or after such date. The TIPRA modifications do not apply to any calendar year after 2010. Thus, the TIPRA modifications do not apply with respect to interest imputed after December 31, 2010. After such date, the law as in effect prior to enactment applies.

---

[1166] Sec. 7872(g)(4).
[1167] Sec. 7872(h).
[1168] Sec. 7872(h)(2).

### *Explanation of Provision*

The provision makes permanent the TIPRA modifications to section 7872 regarding below-market loans to qualified continuing care facilities.

### *Effective Date*

The provision is effective as if included in section 209 of the TIPRA.

## 25. Tax technical corrections (sec. 426 of the Act)

### *In general*

The Act includes technical corrections to recently enacted tax legislation. Except as otherwise provided, the amendments made by the technical corrections contained in the Act take effect as if included in the original legislation to which each amendment relates.

### *Amendment related to the Tax Increase Prevention and Reconciliation Act of 2005*

*Look-through treatment and regulatory authority (Act sec. 103(b)).*–Under the Act, for taxable years beginning after 2005 and before 2009, dividends, interest (including factoring income which is treated as equivalent to interest under sec. 954(c)(1)(E)), rents, and royalties received by one controlled foreign corporation ("CFC") from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to non-subpart F income of the payor (the "TIPRA look-through rule"). The Act further provides that the Secretary shall prescribe such regulations as are appropriate to prevent the abuse of the purposes of the rule.

Section 952(b) provides that subpart F income of a CFC does not include any item of income from sources within the United States which is effectively connected with the conduct by such CFC of a trade or business within the United States ("ECI") unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a tax treaty. Thus, for example, a payment of interest from a CFC all of the income of which is U.S.-source ECI (and therefore not subpart F income) may receive the unintended benefit of the TIPRA look-through rule under the Act, even though the payment may be deductible for U.S. tax purposes.

The provision conforms the TIPRA look-through rule to the rule's purpose of allowing U.S. companies to redeploy their active foreign earnings (i.e., CFC earnings subject to U.S. tax deferral) without an additional tax burden in appropriate circumstances. Under the provision, in order to be excluded from foreign personal holding company income under the TIPRA look-through rule, the dividend, interest, rent, or royalty also must not be attributable or properly allocable to income of the related party payor that is treated as ECI. Thus, for example, a payment of interest made by a CFC does not qualify under the TIPRA look-through rule to the extent that the interest payment is allocated to the CFC's ECI. This is the case even if the interest payment creates or increases a net operating

loss of the CFC. The rule applies to dividends, notwithstanding that dividends are not deductible.

The provision clarifies the authority of the Secretary to issue regulations under the TIPRA look-through rule, as amended by this provision. It is intended that the Secretary will prescribe regulations that are necessary or appropriate to carry out the amended TIPRA look-through rule, including, but not limited to, regulations that prevent the inappropriate use of the amended TIPRA look-through rule to strip income from the U.S. income tax base. Regulations issued pursuant to this authority may, for example, include regulations that prevent the application of the amended TIPRA look-through rule to interest deemed to arise under certain related party factoring arrangements pursuant to section 864(d), or under other transactions the net effect of which is the deduction of a payment, accrual, or loss for U.S. tax purposes without a corresponding inclusion in the subpart F income of the CFC income recipient, where such inclusion would have resulted in the absence of the amended TIPRA look-through rule.

### *Amendment related to the American Jobs Creation Act of 2004*

*Modification of effective date of exception from interest suspension rules for certain listed and reportable transactions (Act sec. 903).*– Section 903 of the American Jobs Creation Act of 2004 ("AJCA"), as modified by section 303 of the Gulf Opportunity Zone Act of 2005, provides that the Secretary of the Treasury may permit interest suspension where taxpayers have acted reasonably and in good faith. For provisions that are included in the Code, section 7701(a)(11) provides that the term "Secretary of the Treasury" means the Secretary in his non-delegable capacity, and the term "Secretary" means the Secretary or his delegate. However, section 903 of AJCA (as modified) is not included in the Code. To clarify that the Secretary may delegate authority under section 903 of AJCA (as modified), the provision adds the words "or the Secretary's delegate" following the reference to the Secretary of the Treasury.

## II. DIVISION C—OTHER PROVISIONS

## TITLE II—SURFACE MINING CONTROL AND RECLAMATION ACT AMENDMENTS OF 2006 [1169]

### 1. Coal Industry Retiree Health Benefit Act

#### (a) Prepayment of premium liability for coal industry health benefits and modification to definition of successor in interest (sec. 211 of the Act and secs. 9701, 9704, 9711, and 9712 of the Code)

***Present Law***

The United Mine Workers of America ("UMWA") Combined Benefit Fund was established by the Coal Industry Retiree Health Benefit Act of 1992 (the "Coal Act") to assume responsibility of payments for medical care expenses of retired miners and their dependents who were eligible for health care from the private 1950 and 1974 UMWA Benefit Plans. The Combined Benefit Fund is financed by assessments on current and former signatories to labor agreements with the UMWA, past transfers from an overfunded United Mine Workers pension fund, and transfers from the Abandoned Mine Reclamation Fund. The Social Security Administration is responsible for assigning eligible retired miners and their dependents to current and former signatories to labor agreements with the UMWA and calculating annual contributions to be paid by each such signatory for each beneficiary assigned to the signatory. The Coal Act uses the term "assigned operator" to refer to the signatory to which liability for a particular beneficiary of the Combined Benefit Fund has been assigned. Under the Coal Act, related persons [1170] to signatories to the relevant labor agreements may have joint and several liability for premium payments. A related person operator includes a member of the same controlled group of corporations as a signatory, a trade or business which is under common control with such signatory, any other person who is identified as having a partnership interest or joint venture with a signatory. A successor in interest to a related person is considered a related person with respect to the signatory operator.

In addition, continuation of certain individual coal industry employer plans is required under the Coal Act. The most recent coal industry employer (the "last signatory operator") of a coal industry retiree who, as of February 1, 1993, was receiving retiree health benefits from an individual employer plan maintained pursuant to a 1978 or subsequent coal wage agreement is required to continue to provide health benefits coverage to such individual and his or

[1169] Subtitle A (secs. 201–209 of the bill) includes changes to the Surface Mining Control and Reclamation Act and other non-tax changes not described in this explanation.
[1170] Sec. 9701(c)(2).

her eligible beneficiaries which is substantially the same as (and subject to all the limitations of) the coverage provided by such plan as of January 1, 1992.[1171] The related persons of a last signatory operator which is required to provide such health benefits coverage is jointly and severally liable with the last signatory operator for such coverage.

The Coal Act also established the 1992 UMWA Benefit Plan to provide health benefits to individuals not receiving benefits from either the Combined Benefit Fund or individual employer plans.[1172] Joint and several liability also applies to related persons of last signatory operators for amounts required to be paid to the 1992 UMWA Benefit Plan.

### *Explanation of Provision*

The provision allows certain assigned operators to prepay their premium liability to the Combined Benefit Fund. The prepayment is available only if (1) the assigned operator (or a related person) made contributions to the 1950 UMWA Benefit Plan and the 1974 UMWA Benefit Plan for employment during the period covered by an 1988 agreement and is not a 1988 agreement operator; (2) the assigned operator and all related persons are not actively engaged in the production of coal as of July 1, 2005; and (3) the assigned operator was, as of July 20, 1992, a member of a controlled group of corporations the common parent of which is publicly traded. For purposes of this description, an operator that meets these requirements is referred to as an "eligible operator". Under the provision, only the parent (and no other person) is liable for the premiums of an assigned operator which is a member of the parent's controlled group if: (1) a payment to the Combined Benefit Fund meeting certain requirements is made; and (2) the parent is jointly and severally liable for any premium which would otherwise be required to be paid by the operator.

Under the provision, in order for the relief from liability to apply: (1) the payment by the assigned operator (or any related person on behalf of the assigned operator) must be no less than the present value of the total premium liability of the assigned operator (or related persons or their assignees), as determined by the operator's (or related person's) enrolled actuary, using actuarial methods and assumptions each of which is reasonable and which are reasonable in the aggregate (as determined by such actuary); and (2) the enrolled actuary must file with the Department of Labor an actuarial report regarding the valuation made by the actuary. The report must contain the date of the actuarial valuation and a statement by the enrolled actuary signing the report that, to the best of the actuary's knowledge, the report is complete and accurate and that in the actuary's opinion the actuarial assumptions used are in the aggregate reasonably related to the experience of the operator and to reasonable expectations. The Secretary of Labor has 90 days after the filing of the report to notify the operator in writing if the Secretary believes the applicable requirements have not been satisfied.

---

[1171] Sec. 9711(a).
[1172] Sec. 9712.

The Combined Fund must establish and maintain an account for each assigned operator making a qualified prepayment and must use all amounts in such account exclusively to pay premiums that would otherwise be required to be paid by the assigned operator. Upon termination of the obligations for premium liability of any assigned operator (or related person) for which such account is maintained, all funds remaining the in account (and earning thereon) shall be refunded to the entity as designated by the parent of the controlled group.

The provision also modifies the rules for joint and several liability of last signatory operators, and related parties to such operators, in the case of individual employer plans under Code section 9711. Under the provision, if security meeting certain requirements is provided on behalf of an assigned operator who meets the requirements for an eligible operator, then, as of the date that security is required, the last signatory operator and related persons are relieved of joint and several liability with respect to such last signatory operator if the common parent of the controlled group remains liable for the provision of benefits otherwise required.

The security must be provided to the trustees of the 1992 UMWA Benefit Plan, solely for the purpose of paying premiums for eligible beneficiaries, and must be equal to one year's premium liability of the last signatory operator (determined using the average cost of the operator's liability during the prior three years). The security must remain in place for five years. The remaining amount of any security must be returned upon the earlier of (1) termination of the obligations of the last signatory operator or (2) five years. The security must be in the form of a bond, letter of credit, or cash escrow and must be in addition to any otherwise required security.

Similar rules apply in the case of joint and several liability obligations under the 1992 UMWA benefit plan.

Under the provision, successors in interest do not include any person (1) who is an unrelated person to a seller who is an eligible operator (or a related person), and (2) who purchases from such seller, assets, or all of the stock of a related person to such seller, for fair market value in a bona fide, arm's-length sale. Thus, such persons are not subject to joint and several liability.

### *Effective Date*

The provisions are generally effective on the date of enactment except that the changes to the definition of successor in interest are effective for transactions after the date of enactment.

### (b) Other provisions (secs. 212 and 213 of the Act and secs. 9702, 9704, 9705, 9706, 9712 and 9721 of the Code)

The provision makes other changes to the Internal Revenue Code, including changes relating to certain premium adjustments, transfers of certain amounts, and the board of trustees of the Combined Fund.

## TITLE IV—OTHER PROVISIONS

### 1. Clarification of prohibition of delivery sales of tobacco products (sec. 401 of the Act and sec. 5761 of the Code)

#### *Present Law*

Tobacco products are subject to Federal excise tax on their manufacture or importation into the United States.[1173] The tax is imposed on the manufacturer or importer and is determined at the time of removal.[1174] Personal use quantities exempt from payment of customs duty under certain portions of the Harmonized Tariff Schedule ("HTS") are also exempt from payment of internal revenue tax imposed by reason of importation.[1175] In general, entry of 200 cigarettes (i.e., one carton) is permitted free of duty and tax, but only if the article is accompanying the person arriving in the United States.[1176]

Tobacco products may be removed without payment of tax for shipment to a foreign country or a possession of the United States or for consumption outside the United States.[1177] Such tobacco products must be labeled for export, and may not be sold or held for sale in the United States unless repackaged into new packaging that does not contain an export label.[1178] There are penalties for violation of these rules. In general, every person who sells, relands, or receives within the jurisdiction of the United States any tobacco products which have been labeled or shipped for exportation, and every person who sells or receives such relanded tobacco products or who aids or abets in such selling, relanding or receiving, is liable for a penalty equal to the greater of $1,000 or 5 times the amount of excise tax imposed under the law, in addition to the excise tax. All tobacco products so relanded are to be forfeited to the United States and destroyed. In addition, all vessels, vehicles and aircraft used in such relanding or in removing such products from the place where relanded are to be forfeited to the United States. However, quantities allowed entry free of tax and duty under Subchapter IV of chapter 98 of the HTS are exempt from these rules.[1179]

Subject to certain exemptions, including an exemption for personal use quantities that are allowed entry free of tax and duty under the HTS, imported cigarettes are subject to certain labeling, trademark, and certification requirements under applicable cus-

---

[1173] While excise tax rates vary by tobacco product, the most common product, cigarettes weighing not more than 3 pounds per thousand, is taxed at a rate of $19.50 per thousand (i.e., 39 cents per pack of 20 cigarettes). Sec. 5701(b)(1).

[1174] Sec. 5703(b).

[1175] Harmonized Tariff Schedule of the United States (2005) ("HTS"), Chapter 98, U.S. Note 1. The HTS has the status of a statute of the United States. 19 U.S.C. sec. 3004(c)(1).

[1176] HTS, chapter 98, subchapter IV, sec. 9804.00.72.

[1177] Sec. 5704(b).

[1178] Sec. 5754(a)(1)(C).

[1179] Sec. 5761(c).

toms law.[1180] Customs law also provides for penalties, forfeiture, and destruction of noncompliant products.[1181]

### *Explanation of Provision*

The provision clarifies that, for purposes of the penalties with respect to the reimportation of exported tobacco products, the personal use exemption from the Federal excise tax on imports of tobacco products does not apply to any tobacco product sold in connection with a delivery sale. A "delivery sale" is any sale of a tobacco product to a consumer (1) if the consumer submits the order by telephone, other voice transmission, internet or other online service, or if the seller is not in the physical presence of the buyer when the request for purchase is made, or (2) if the product is delivered by common carrier, private delivery service, or the mail, or if the seller is not in the physical presence of the buyer when the buyer obtains physical possession of the product. The provision clarifies that any delivery sale of a tobacco product is subject to Federal excise tax upon its reimportation, regardless of the quantity sold.

The provision also covers smokeless tobacco under the labeling, trademark, and certification requirements, and the related enforcement provisions, which generally apply under applicable customs law to imported cigarettes. In addition, the provision clarifies that delivery sales of personal use quantities of cigarettes and smokeless tobacco are not exempt from the customs requirements and enforcement rules.

The provision also grants the States access to customs certifications and the power to cause the forfeiture and destruction of noncompliant tobacco products.

### *Effective Date*

The provision applies to goods entered, or withdrawn from a warehouse for consumption, on or after the 15th day after the date of enactment.

## 2. Exclusion of 25 percent of capital gain for certain sales of mineral and oil leases for conservation purposes (sec. 403 of the Act)

### *Present Law*

Gain from the sale or exchange of land held more than one year generally is treated as long-term capital gain. Generally, the net capital gain of an individual is subject to a maximum tax rate of 15 percent. The net capital gain of a corporation is subject to tax at the same rate as ordinary income.

### *Explanation of Provision*

#### *In general*

The provision provides a 25-percent exclusion from gross income of long-term capital gain from the conservation sale of a qualifying

[1180] 19 U.S.C. sec. 1681a.
[1181] 19 U.S.C. sec. 1681b.

mineral or geothermal interest.[1182] The conservation sale must be made to an eligible entity that intends that the acquired property be used for qualified conservation purposes in perpetuity.[1183]

### *Qualifying interests*

A qualifying mineral or geothermal interest means an interest in any mineral or geothermal deposit located on eligible Federal land which constitutes a taxpayer's entire interest in such deposit. Eligible Federal land means (1) Bureau of Land Management land and any Federally-owned minerals located south of the Blackfeet Indian Reservation and East of the Lewis and Clark national Forest to the Eastern edge of R. 8 W., beginning in T. 29 N. down to and including T. 19 N. and all of T. 18 N., R. 7 W, (2) the Forest Service land and any Federally-owned minerals located in the Rocky Mountain Division of the Lewis and Clark National Forest, including the approximately 356,111 acres of land made unavailable for leasing by the August 28, 1997, Record of Decision for the Lewis and Clark National Forest Oil and Gas Leasing Environmental Impact Statement and that is located form T. 31 N. to T. 16 N. and R. 13 W. to R. 7 W., and (3) the Forest Service land and any Federally-owned minerals located within the Badger Two Medicine area of the Flathead National Forest, including the land located in T. 29 N. from the Western edge of R. 16 W. to the Eastern edge of R. 13 W. and the land located in T. 28 N., R. 13 and 14 W. All such land is as generally depicted on the map entitled "Rocky Mountain Front Mineral Withdrawal Area" and dated December 31, 2006. The map shall be on file and available for inspection in the Office of the Chief of the Forest Service.

An interest in property is not the entire interest of the taxpayer if such interest was divided in an attempt to avoid the requirement that the taxpayer sell the taxpayer's entire interest in the property. An interest may be considered the taxpayer's entire interest notwithstanding that the taxpayer retains an interest in other deposits, even if the other deposits are contiguous with the sold deposit and were acquired by the taxpayer along with such deposit in a single conveyance. It is intended that the partial interest rules contained in Treasury Regulations section 1.170A–7(a)(2)(i) and generally applicable to charitable contributions of partial interests be applied similarly for purposes of this provision.

### *Conservation sales*

A conservation sale is a sale (excluding a transfer made by order of condemnation or eminent domain) to an eligible entity, defined as a Federal, State, or local government, or an agency or department thereof or a section 501(c)(3) organization that is organized and operated primarily to meet a qualified conservation purpose. In

---

[1182] In a non tax-related provision, the provision also provides that, subject to valid existing rights, eligible Federal land (including any interest in eligible Federal land) is withdrawn from: (1) all forms of location, entry, and patent under the mining laws; and (2) disposition under all laws relating to mineral and geothermal leasing.

[1183] The exclusion is mandatory if all of the requirements of the provision are satisfied, and a taxpayer need not file an election to take advantage of the exclusion. A taxpayer who transfers qualifying property to a qualified organization may opt out of the 25-percent exclusion by choosing not to satisfy one or more of the provision's requirements without having to file a formal election with the Secretary, such as by failing to obtain the requisite letter of intent from the qualified organization.

addition, to be a conservation sale, the organization acquiring the property interest must provide the taxpayer with a written letter stating that the acquisition will serve one or more qualified conservation purposes, that the use of the deposits will be exclusively for conservation purposes, and that such use will continue in the event of a subsequent transfer of the acquired interest. A qualified conservation purpose is: (1) the preservation of land areas for outdoor recreation by, or the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; or (3) the preservation of open space (including farmland and forest land) where the preservation is for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy and will yield a significant public benefit. Use of property is not considered to be exclusively for conservation purposes unless the conservation purpose is protected in perpetuity and no surface mining is permitted with respect to the property (sec. 170(h)(5)).

***Protection of conservation purposes***

The provision provides for the imposition of penalty excise taxes if an eligible entity fails to take steps consistent with the protection of conservation purposes. If ownership or possession of the property is transferred by a qualified organization, then: (1) a 20-percent excise tax applies to the fair market value of the property, and (2) any realized gain or income is subject to an additional excise tax imposed at the highest income tax rate applicable to C corporations. In the case of a transfer by an eligible entity to another eligible entity, the excise tax does not apply if the transferee provides the transferor at the time of the transfer a letter of intent (as described above). In the case of a transfer by an eligible entity to a transferee that is not an eligible entity, the excise tax does not apply if it is established to the satisfaction of the Secretary that the transfer is exclusively for conservation purposes (as provided in section 170(h)(5)) and the transferee provides the transferor a letter of intent (as described above) at the time of the transfer. Once a transfer has been subject to the excise tax, the excise tax may not apply to any subsequent transfers. The provision provides that the Secretary may require such reporting as may be necessary or appropriate to further the purpose that any conservation use be in perpetuity.

### *Effective Date*

The provision is effective for sales occurring on or after the date of enactment.

### 3. Tax court review of requests for equitable relief from joint and several liability (sec. 408 of the Act and sec. 6015 of the Code)

### *Present Law*

***In general***

Generally, a husband and wife are liable jointly and individually for the entire tax on a joint return. Under certain circumstances,

a spouse may be entitled to relief from joint and several liability, "innocent spouse relief."[1184] Generally, the spouse must elect the form of innocent spouse relief no later than two years after the date the IRS began collection activities against the electing spouse.

There are three types of relief, general innocent spouse relief, relief for spouses no longer married or legally separated (separation of liabilities), and equitable relief.

For general relief, the electing spouse must

- Have filed a joint return that has an understatement of tax due to the erroneous items of the other spouse,
- Establish that at the time of signing the return the electing spouse did not know or have reason to know there was an understatement of tax, and
- Taking into account all the facts and circumstances, show that it is inequitable to hold the electing spouse liable for the deficiency in tax.[1185]

For separation of liabilities relief, the electing spouse

- Must have filed a joint return and,
- Either (1) is no longer married to or is legally separated from the spouse with whom the return was filed or (2) must not have been a member of the same household with the spouse for a 12-month period.[1186]

If an individual fails to qualify under the preceding two options, such individual may still be able to obtain equitable relief.[1187] To obtain equitable relief, the IRS must determine that taking into account all of the facts and circumstances, it is inequitable to hold the electing spouse liable for any unpaid tax or any deficiency in tax (or any portion of either).

In the case of an individual against whom a deficiency has been asserted and elects to have the general relief provisions or the separation of liabilities relief provisions apply, such individual may petition the Tax Court to review the IRS's determinations.

Some courts have noted the absence of an express statement of Tax Court jurisdiction over equitable relief claims in the statute.[1188] Other courts have rejected Tax court jurisdiction over such claims on the basis that a deficiency has not been asserted against the claimant.[1189] Recently, the United States Tax Court revisited its prior ruling that it had jurisdiction over nondeficiency standalone petitions for equitable relief. In light of adverse rulings in the Eighth and Ninth Circuits this year, the Tax Court in *Billings vs.*

---

[1184] Sec. 6015.

[1185] Sec. 6015(b).

[1186] Sec. 6015(c).

[1187] Sec. 6015(f).

[1188] The Second Circuit has noted that the question of the Tax Court's jurisdiction over an appeal of an adverse determination under section 6015(f) is "not free from doubt." *Maier* v. *Comm'r*, 360 F.3d 361, 363 n. 1 (2d cir. 2004). The court pointed out that "only petitions to review IRS determinations under subsections (b) and (c) are expressly enumerated in section 6015(e) and (h)." Id.; see also *French* v. *United States (In re French)*, 255 B.R. 1, 2 (Bankr.N.D.Ohio 2000) (dismissing for lack of jurisdiction the debtor's claim that she was entitled to relief under § 6015(f) because "Congress chose to exclude from judicial review the issue of whether a taxpayer is entitled to equitable relief under § 6015(f)"); *Mira* v. *United States (In re Mira)*, 245 B.R. 788, 791–92 (Bankr.M.D.Pa.1999) (reasoning that sec. 6015(f) grants the Secretary of the Treasury discretion to grant equitable relief and, as a decision "committed to agency discretion by law," 5 U.S.C. sec. 701, it was not reviewable by the court).

[1189] *Comm'r* v. *Ewing*, 439 F.3d 1009, 1012–14 (9th Cir. 2006) rev'g *Ewing* v. *Comm'r.,* 118 T.C. 494 (2002); and *Bartman* v. *Comm'r*, 446 F.3d 785, 787 (8th Cir. 2006).

*Commissioner*, recently held that it does not have jurisdiction over such claims in the absence of a deficiency.[1190]

### *Restrictions on collection and suspension of the running of the period of limitations*

Unless the IRS determines that collection will be jeopardized by delay, no levy or proceeding in court is to be made, begun or prosecuted against a spouse seeking general innocent spouse relief or separation of liabilities relief for the collection of any assessment to which the election relates until (1) the expiration of the 90-day period following the date of mailing of the Service's final determination letter, or (2) if a petition is filed with the Tax Court, until the decision of the Tax Court becomes final.[1191]

For the spouse seeking general or separation of liabilities relief, the running of the period of limitations on collections of the assessment to which the election relates is suspended for the period during which the IRS is prohibited from collecting by levy or proceeding in court and for 60 days thereafter. However, the requesting spouse may waive the restrictions on collection and the suspension of the period of limitations against collection will terminate 60 days after the date the waiver is filed with the IRS.[1192]

## *Explanation of Provision*

The provision clarifies that the Tax Court has jurisdiction over equitable relief claims, even if the individual does not elect to have the general relief or separation of liabilities relief provisions apply and no deficiency is asserted. The provision also extends the present law suspension of collection activity and tolling of the period of limitations provisions to equitable relief claims.

## *Effective Date*

The provision applies to requests for equitable relief with respect to liability for taxes arising or remaining unpaid on or after the date of enactment.

---

[1190] *Billings* v. *Commissioner*, 127 T.C. No. 2 (July 25, 2006) (holding that the Court lacks jurisdiction to review the Commissioner's decisions to deny relief under section 6015(f) when there is no deficiency but tax went unpaid). In *Billings*, the IRS had accepted the petitioner's amended return as filed and asserted no deficiency against him. His request for equitable relief from the unpaid tax arising from his wife's embezzlement was denied by the IRS.

[1191] Sec. 6015(e)(1)(B) and Treas. Reg. sec. 1.6015–1(c)(1).

[1192] Sec. 6015(e)(2) and (5); and Treas. Reg. sec. 1.6015–1(c)(3).

## PART FIFTEEN: FALLEN FIREFIGHTERS ASSISTANCE TAX CLARIFICATION ACT OF 2006 (PUBLIC LAW 109–445)[1193]

### A. Payments by Certain Charitable Organizations for the Benefit of Firefighters Who Died as a Result of the Esperanza Fire Treated as Exempt Payments (sec. 2 of the Act)

#### *Present Law*

In general, organizations described in section 501(c)(3) are exempt from taxation. Such organizations are classified either as private foundations or non private foundations (generally referred to as public charities). Public charities include organizations that receive broad public support (sec. 509(a)(1) or sec. 509(a)(2)), supporting organizations (sec. 509(a)(3)), and organizations organized and operated for testing for public safety (sec. 509(a)(4)).

Contributions to section 501(c)(3) organizations generally are tax deductible (sec. 170). Section 501(c)(3) organizations must be organized and operated exclusively for exempt purposes and no part of the net earnings of such organizations may inure to the benefit of any private shareholder or individual. An organization is not organized or operated exclusively for one or more exempt purposes unless the organization serves a public rather than a private interest. Thus, an organization described in section 501(c)(3) generally must serve a charitable class of persons that is indefinite or of sufficient size.

#### *Explanation of Provision*

Under the provision, payments made on behalf of any firefighter who died as the result of the October 2006 Esperanza Incident fire in southern California to any family member of such a firefighter by a public charity (as described in section 509(a)(1) and (a)(2)) are treated as related to the purpose or function constituting the basis for the organization's exempt status, if the payments are made in good faith using a reasonable and objective formula that is consistently applied.

#### *Effective Date*

The provision applies to payments made on or after October 26, 2006, and before June 1, 2007.

[1193] H.R. 6429. The House passed the bill without objection on December 8, 2006. The Senate passed the bill by unanimous consent on the same date. The President signed the bill on December 21, 2006.

# APPENDIX:
# ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 109TH CONGRESS

**APPENDIX:**
**ESTIMATED BUDGET EFFECTS OF TAX LEGISLATION ENACTED IN THE 109TH CONGRESS**

**Fiscal Years 2005 - 2016**

*[Millions of Dollars]*

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **PART ONE: TSUNAMI RELIEF - Acceleration of Income Tax Benefits for Charitable Cash Contributions for Relief of Indian Ocean Tsunami Victims (P.L. 109-1, signed into law by the President on January 7, 2005)** | **DOE** | **-1** | **-1** | **---** | **---** | **---** | **---** | **---** | **---** | **---** | **---** | **---** | **---** | **-2** |
| **PART TWO: EXTENSION OF LEAKING UNDERGROUND STORAGE TANK TRUST FUND FINANCING RATE (SUNSET 9/30/05) (P.L. 109-6, signed into law by the President on March 31, 2005)** | **DOE** | ***No Revenue Effect*** | | | | | | | | | | | | |
| **PART THREE: TAX TREATMENT OF CERTAIN DISASTER MITIGATION PAYMENTS (P.L. 109-7, signed into law by the President on April 15, 2005)** | **arbo/a DOE** | **---** | **-6** | **-7** | **-6** | **-8** | **-10** | **-12** | **-14** | **-15** | **-16** | **-16** | **---** | **-109** |
| **PART FOUR: SURFACE TRANSPORTATION EXTENSION ACT OF 2005, PARTS I-VI - Extensions of Surface Transportation Act (P.L. 109-14, signed into law by the President on May 31, 2005; P.L. 109-20, signed into law by the President on July 1, 2005; P.L. 109-35, signed into law by the President on July 20, 2005; P.L. 109-37, signed into law by the President on July 22, 2005; P.L. 109-40, signed into law by the President on July 28, 2005; and P.L. 109-42, signed into law by the President on July 30, 2005)** | **DOE** | ***No Revenue Effect*** | | | | | | | | | | | | |
| **PART FIVE: THE ENERGY POLICY ACT OF 2005 (P.L. 109-58, signed into law by the President on August 8, 2005)** | | | | | | | | | | | | | | |
| A. Energy Tax Policy Incentives | | | | | | | | | | | | | | |
| 1. Extend and modify section 45 credit through 12/31/07 (allow pass through of credit to cooperative patrons) [1] | DOE & tyea DOE | -1 | -35 | -134 | -256 | -314 | -328 | -342 | -351 | -334 | -326 | -327 | --- | -2,747 |
| 2. Clean renewable energy bonds ($800 million aggregate issuance limitation through 12/31/07) | bia 12/31/05 | --- | -9 | -25 | -42 | -48 | -48 | -48 | -48 | -48 | -48 | -48 | --- | -411 |
| 3. Treatment of certain income of electric cooperatives | DOE | --- | --- | -14 | -24 | -26 | -29 | -32 | -34 | -37 | -39 | -42 | --- | -277 |
| 4. Dispositions of transmission property to implement FERC restructuring policy (applies to sales or dispositions completed prior to 1/1/08) | DOE | -37 | -105 | -237 | -73 | 43 | 43 | 44 | 45 | 82 | 150 | 64 | --- | 19 |
| 5. Credit for production from advanced nuclear power facilities | tyba DOE | --- | --- | --- | --- | --- | --- | --- | -- | -41 | -83 | -155 | --- | -278 |
| 6. Credit for investment in clean coal facilities | pa DOE [2] | --- | -26 | -55 | -101 | -151 | -212 | -254 | -260 | -238 | -178 | -136 | --- | -1,612 |
| 7. Electricity transmission property rated 69kV or greater treated as 15-year property [3] | ppisa 4/11/05 | --- | -3 | -18 | -45 | -78 | -110 | -140 | -166 | -194 | -225 | -261 | --- | -1,239 |
| 8. 84-month amortization of qualified air pollution control facilities installed in post-1975 coal-fired electric generation plants | ppisa 4/11/05 | -2 | -10 | -30 | -58 | -89 | -123 | -154 | -177 | -187 | -173 | -144 | --- | -1,147 |

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 9. Modification to special rules for nuclear decommissioning costs - eliminate cost of service requirement, permit transfer for pre-1984 decommissioning costs to qualified fund (seller gets deduction on sale of plant), and permit full funding in qualified fund | tyba 12/31/05 | --- | -120 | -199 | -187 | -168 | -126 | -116 | -107 | -97 | -90 | -83 | --- | -1,293 |
| 10. Temporary 5-year net operating loss carryover for certain electric companies limited to 20% of combined qualifying investment in transmission and pollution control equipment | [4] | --- | -72 | -43 | -19 | 19 | 16 | 12 | 10 | 8 | 8 | 8 | --- | -52 |
| 11. Extension of credit for producing fuel from a nonconventional source for facilities producing coke or coke gas (sunset for facilities placed in service after 12/31/09) | pa 12/31/05 | --- | -5 | -12 | -17 | -23 | -19 | -13 | -8 | -2 | --- | --- | --- | -101 |
| 12. Allow section 29 credit to be component of general business credit (produced and sold through 12/31/07) | [5] | --- | --- | -275 | -301 | 24 | 46 | 66 | 88 | 88 | 88 | 88 | --- | -88 |
| 13. Temporary 50% expensing for equipment used in the refining of liquid fuels (and allow pass through to cooperative owners) (sunset 12/31/11) [6] | ppisa DOE | --- | -12 | -31 | -119 | -238 | -259 | -183 | 49 | 156 | 126 | 105 | --- | -406 |
| 14. Pass through low sulfur diesel expensing to cooperative owners | [7] | -42 | -3 | 5 | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 4 | --- | -7 |
| 15. Natural gas distribution pipelines treated as 15-year property (sunset after 12/31/10) [3] | ppisa 4/11/05 | -1 | -13 | -43 | -78 | -110 | -139 | -152 | -137 | -120 | -114 | -112 | --- | -1,019 |
| 16. Natural gas gathering pipelines treated as 7-year property with AMT relief [3] | ppisa 4/11/05 | --- | -1 | -3 | -2 | -2 | -2 | -1 | -1 | -1 | -1 | -1 | --- | -16 |
| 17. Exempt certain prepayments for natural gas from tax-exempt bond arbitrage rules | bia DOE | [8] | -1 | -2 | -3 | -4 | -4 | -5 | -7 | -8 | -9 | -10 | --- | -53 |
| 18. Determination of small refiner exception to oil depletion deduction - modify definition of independent refiner from daily maximum run less than 50,000 barrels to average daily run less than 75,000 barrels | tyea DOE | -2 | -14 | -14 | -15 | -15 | -15 | -16 | -16 | -16 | -17 | -18 | --- | -158 |
| 19. Amortize all geological and geophysical expenditures over 2 years | apoii tyba DOE | 127 | 165 | -59 | -201 | -218 | -151 | -122 | -131 | -125 | -125 | -134 | --- | -974 |
| 20. Allowance of deduction for certain energy efficient commercial building property (sunset 12/31/07) | ppisa 12/31/05 | --- | -81 | -141 | -48 | 6 | 5 | 5 | 4 | 4 | 3 | 3 | --- | -243 |
| 21. Credit for construction of new energy efficient homes (sunset 12/31/07) | hpa 12/31/05 | --- | -6 | -9 | -5 | -3 | -3 | -2 | -2 | -1 | [9] | --- | --- | -28 |
| 22. Credit for energy efficiency improvements to existing homes (sunset 12/31/07) | ppisa 12/31/05 | --- | -55 | -275 | -226 | --- | --- | --- | --- | --- | --- | --- | --- | -556 |
| 23. Credit for energy efficient appliances (sunset 12/31/07) [10] | apa 12/31/05 | --- | -117 | -63 | --- | --- | --- | --- | --- | --- | --- | --- | --- | -180 |
| 24. 30% credit for residential purchases/installations of solar (pv and hot water) and fuel cells (sunset 12/31/07) | ppisa 12/31/05 | --- | -2 | -13 | -16 | --- | --- | --- | --- | --- | --- | --- | --- | -31 |
| 25. Credit for business installation of qualified fuel cells and stationary microturbine power plants (sunset 12/31/07) | [11] | --- | -19 | -82 | -110 | -30 | -18 | -7 | 6 | 10 | 15 | 12 | --- | -222 |
| 26. Business solar investment tax credit (generally sunset 12/31/07) | [12] | --- | -4 | -7 | -5 | -3 | -2 | -2 | -1 | --- | --- | --- | --- | -24 |
| 27. Alternative motor vehicle credit | ppisa 12/31/05 | --- | -283 | -254 | -142 | -110 | -19 | -12 | -11 | -15 | -19 | -10 | --- | -874 |
| 28. Sunset of deduction for clean-fuel vehicles and certain refueling property 12/31/05 | 1/1/06 | --- | 8 | 2 | -3 | -2 | -2 | -1 | --- | --- | --- | --- | --- | 2 |
| 29. Credit for installation of alternative fueling stations for property placed in service before 1/1/10 (1/1/15 for hydrogen property) | ppisa 12/31/05 | --- | -3 | -9 | -13 | -19 | -14 | -6 | -5 | -2 | [13] | 2 | --- | -71 |
| 30. Reduced motor fuel excise tax rate for diesel fuel blended with water [14] | 1/1/06 | --- | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | --- | [9] |
| 31. Extend excise tax provisions and income tax credit for biodiesel and create similar incentives for renewable diesel (sunset 12/31/08) | DOE & fsoua 12/31/05 | --- | --- | -67 | -101 | -26 | --- | --- | --- | --- | --- | --- | --- | -194 |

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 32. Establish small agri-biodiesel producer credit (sunset 12/31/08) and expand eligibility for small ethanol producer credit (increase productive capacity to 60 million gallons) | tyea DOE | -1 | -22 | -24 | -28 | -26 | -26 | -23 | -14 | -11 | -5 | --- | --- | -181 |
| 33. R&E tax credit for energy research (sunset 12/31/05) | epoia DOE | -3 | -10 | -35 | -21 | -11 | -8 | -4 | -1 | --- | --- | --- | --- | -92 |
| 34. National Academy of Sciences study | DOE | *No Revenue Effect* | | | | | | | | | | | | |
| 35. Recycling study | DOE | *No Revenue Effect* | | | | | | | | | | | | |
| 36. Oil Spill Liability Trust Fund financing rate (sunset 12/31/14) | [15] | --- | 150 | 254 | 276 | 282 | 285 | 290 | 293 | 298 | 303 | 76 | --- | 2,508 |
| 37. Extend Leaking Underground Storage Tank ("LUST") Trust Fund financing rate (sunset 9/30/11), expand to apply financing rate to all fuels, and repeal LUST refunds | 10/1/05 & freosa 9/30/05 | --- | 33 | 34 | 34 | 35 | 35 | 35 | 35 | 35 | 36 | 36 | --- | 349 |
| 38. Modify recapture of section 197 amortization | dopa DOE | 2 | 12 | 13 | 14 | 15 | 16 | 17 | 19 | 20 | 21 | 23 | --- | 171 |
| 39. Clarify definition of super single tire | [16] | *Negligible Revenue Effect* | | | | | | | | | | | | |
| **TOTAL OF PART FIVE** | | **40** | **-663** | **-1,865** | **-1,931** | **-1,286** | **-1,207** | **-1,162** | **-924** | **-772** | **-698** | **-1,060** | **---** | **-11,525** |
| **PART SIX: SAFE, ACCOUNTABLE, FLEXIBLE, EFFICIENT TRANSPORTATION EQUITY ACT: A LEGACY FOR USERS; TITLE XI - HIGHWAY REAUTHORIZATION AND EXCISE TAX SIMPLIFICATION (P.L. 109-59, signed into law by the President on August 10, 2005)** | | | | | | | | | | | | | | |
| I. Trust Fund Reauthorization | | | | | | | | | | | | | | |
| A. Extend Highway Trust Fund and Aquatic Resources Trust Fund Expenditure Authority Through September 29, 2009, and Related Taxes Through September 30, 2011 | DOE | *No Revenue Effect* | | | | | | | | | | | | |
| B. No Extension of General Fund Retention of 4.8 Cents/Gallon of Taxes on Motorboat and Small Engine Gasoline [17] | 10/1/05 | *No Revenue Effect* | | | | | | | | | | | | |
| II. Excise Tax Reform and Simplification | | | | | | | | | | | | | | |
| A. Highway Excise Taxes | | | | | | | | | | | | | | |
| 1. Modify gas guzzler tax | 10/1/05 | --- | -3 | -4 | -4 | -4 | -5 | -5 | -5 | -5 | -5 | -6 | --- | -46 |
| 2. Exclusion for tractors with a gross vehicle weight rating of 19,500 pounds or less from Federal excise tax on heavy trucks and trailers | sa 9/30/05 | -1 | -2 | -2 | -3 | -3 | -3 | -3 | -3 | -3 | -3 | -3 | --- | -31 |
| 3. Excise tax credit and imposition of tax on alternative fuels [18] | suora 9/30/06 | --- | --- | -162 | -175 | 46 | 25 | 39 | 42 | 44 | 47 | 49 | --- | -44 |
| B. Aquatic Excise Taxes | | | | | | | | | | | | | | |
| 1. Eliminate Aquatic Resources Trust Fund and transform Sport Fish Restoration Account | 10/1/05 | *No Revenue Effect* | | | | | | | | | | | | |
| 2. Repeal harbor maintenance tax on exports [19] | boaa DOE | *No Revenue Effect* | | | | | | | | | | | | |
| 3. Cap excise tax on certain fishing equipment [20] | [21] | --- | -3 | -3 | -4 | -4 | -4 | -4 | -4 | -5 | -5 | -5 | --- | -41 |
| C. Aerial Excise Taxes | | | | | | | | | | | | | | |
| 1. Clarify excise tax exemptions for agricultural aerial applicators and exempt certain fixed-wing aircraft engaged in forestry operations | fuoata 9/30/05 | --- | -4 | -4 | -4 | -4 | -4 | -4 | -4 | -4 | -4 | -4 | --- | -40 |
| 2. Modify the definition of rural airport | 10/1/05 | --- | -3 | -3 | -4 | -4 | -4 | -4 | -4 | -4 | -5 | -5 | --- | -40 |
| 3. Exempt from ticket taxes transportation provided by seaplanes | ta 9/30/05 | --- | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | --- | -11 |
| 4. Exempt certain sightseeing flights from taxes on air transportation | [22] | --- | -7 | -7 | -7 | -7 | -8 | -8 | -8 | -9 | -9 | -9 | --- | -79 |
| D. Taxes Relating to Alcohol | | | | | | | | | | | | | | |
| 1. Repeal special occupational taxes on producers and marketers of alcoholic beverages | 7/1/08 | --- | --- | --- | -50 | -59 | -59 | -59 | -59 | -59 | -59 | -59 | --- | -459 |
| 2. Provide income tax credit for cost of carrying tax-paid distilled spirits in wholesale inventories and in control State bailment warehouses | tyba 9/30/05 | --- | -9 | -17 | -19 | -20 | -20 | -20 | -20 | -21 | -21 | -21 | --- | -188 |

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 3. Quarterly filing by small alcohol producers | qpboaa 1/1/06 | --- | -5 | [23] | [23] | [23] | [23] | [23] | [23] | [23] | [23] | [23] | --- | -6 |
| E. Sports Excise Taxes - Provide Exemption for Certain Custom Gunsmiths [24] | [21] | --- | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | --- | -8 |
| III. Miscellaneous Provisions | | | | | | | | | | | | | | |
| A. Establish a Motor Fuel Tax Enforcement Advisory Commission | DOE | *No Revenue Effect* | | | | | | | | | | | | |
| B. Establish a National Surface Transportation Infrastructure Financing Commission | DOE | *No Revenue Effect* | | | | | | | | | | | | |
| C. Tax-Exempt Financing of Highway Projects and Rail-Truck Transfer Facilities | bia DOE | [23] | -5 | -14 | -25 | -36 | -50 | -72 | -97 | -122 | -146 | -170 | --- | -738 |
| D. Treasury Study of Highway Fuels Used by Trucks for Non-Transportation Purposes | DOE | *No Revenue Effect* | | | | | | | | | | | | |
| E. Diesel Fuel Tax Evasion Report | DOE | *No Revenue Effect* | | | | | | | | | | | | |
| F. State Acquisition of Real Estate Investment Trust Interests | [25] | [23] | [23] | [23] | [23] | [23] | [23] | [23] | [23] | [23] | [23] | [23] | --- | -2 |
| G. Limitation on Transfers to the Leaking Underground Storage Tank Trust Fund | DOE | *No Revenue Effect* | | | | | | | | | | | | |
| IV. Provisions to Combat Fuel Fraud | | | | | | | | | | | | | | |
| A. Treatment of Kerosene Used in Aviation | [26] | --- | 48 | 49 | 50 | 50 | 50 | 50 | 50 | 50 | 49 | 49 | --- | 495 |
| B. Repeal of Ultimate Vendor Refund Claims With Respect to Farming | sa 9/30/05 | --- | [13] | [13] | [13] | [13] | [13] | [13] | [13] | [13] | [13] | [13] | --- | [13] |
| C. Refunds of Excise Taxes on Exempt Sales of Fuel by Credit Card | sa 12/31/05 | *Negligible Revenue Effect* | | | | | | | | | | | | |
| D. Reregistration in Event of Change in Ownership | aoftaa DOE | [13] | 4 | 4 | 4 | 4 | 4 | 4 | 5 | 5 | 5 | 5 | --- | 45 |
| E. Reconciliation of On-Loaded Cargo to Entered Cargo | DOE | --- | [13] | 4 | 4 | 4 | 4 | 4 | 5 | 5 | 5 | 5 | --- | 41 |
| F. Treatment of Deep-Draft Vessels | DOE | [13] | 3 | 2 | 2 | 2 | 2 | 3 | 3 | 3 | 3 | 3 | --- | 26 |
| G. Penalty With Respect to Certain Adulterated Fuels | tsohofsoa DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| V. Fuels-Related Technical Corrections | [27] | *No Revenue Effect* | | | | | | | | | | | | |
| **TOTAL OF PART SIX** | | **-1** | **12** | **-159** | **-237** | **-37** | **-74** | **-81** | **-101** | **-127** | **-150** | **-173** | **---** | **-1,126** |
| **PART SEVEN: THE KATRINA EMERGENCY TAX RELIEF ACT OF 2005 [28] (P.L. 109-73, signed into law by the President on September 23, 2005)** | | | | | | | | | | | | | | |
| I. Special Rules for Use of Retirement Funds for Relief Relating to Hurricane Katrina | | | | | | | | | | | | | | |
| A. Penalty-Free Withdrawals From Retirement Plans for Qualified Hurricane Katrina Distributions (capped at $100,000 per taxpayer); Allow Amount of Distribution to be Repaid to an Eligible Retirement Plan Within Three Years and to be Included in Income Ratably Over Three Years | dma 8/24/05 & before 1/1/07 | --- | -71 | -14 | 13 | 9 | -2 | -1 | -1 | -1 | -1 | -1 | --- | -71 |
| B. Recontributions of Withdrawals for Home Purchases Cancelled Due to Hurricane Katrina | dra 2/28/05 & before 8/29/05 | *Negligible Revenue Effect* | | | | | | | | | | | | |
| C. Loans from Qualified Plans for Relief Relating to Hurricane Katrina | [29] | *Negligible Revenue Effect* | | | | | | | | | | | | |
| II. Employment Relief | | | | | | | | | | | | | | |
| A. Work Opportunity Tax Credit for Certain Individuals Affected by Hurricane Katrina (sunset 12/31/05 for employers outside disaster areas, and 8/28/07 for employers inside disaster areas) | wpoio/a 8/28/05 | --- | -12 | -30 | -28 | -12 | -6 | -3 | -1 | --- | --- | --- | --- | -93 |
| B. Employee Retention Credit for Employers of No More Than 200 Employees Affected by Hurricane Katrina | wpoia 8/28/05 & before 1/1/06 | --- | -23 | -8 | -4 | -2 | --- | --- | --- | --- | --- | --- | --- | -38 |
| III. Charitable Giving Incentives | | | | | | | | | | | | | | |
| A. Temporary Suspension of Limitations for Qualified Corporate and Individual Charitable Contributions (qualified corporate contributions must be for relief efforts related to Hurricane Katrina) | [30] | --- | -819 | 56 | 17 | -3 | -4 | -14 | -26 | -26 | -26 | -26 | --- | -871 |

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| B. Additional $500 Personal Exemption for Hurricane Katrina Displaced Individuals (staying as houseguests for at least 60 days) subject to maximum additional exemptions of $2,000 [31] | tybi 2005 & 2006 | --- | -96 | -32 | --- | --- | --- | --- | --- | --- | --- | --- | --- | -128 |
| C. Increase in Standard Mileage Rate for Charitable Use of a Vehicle for Providing Relief Related to Hurricane Katrina | cmo/a 8/25/05 & before 1/1/07 | --- | -17 | -12 | --- | --- | --- | --- | --- | --- | --- | --- | --- | -29 |
| D. Mileage Reimbursements to Charitable Volunteers Excluded from Gross Income for Providing Relief Related to Hurricane Katrina up to Standard Business Mileage Rate | uopao/a 8/25/05 & before 1/1/07 | --- | -1 | -1 | --- | --- | --- | --- | --- | --- | --- | --- | --- | -2 |
| E. Extend Enhanced Deduction for Contributions of Food Inventory to Individuals | cmo/a 8/28/05 & before 1/1/06 | --- | -20 | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | -20 |
| F. Extend Enhanced Deduction for Contributions of Book Inventory to Include Contributions to Public Schools | cmo/a 8/28/05 & before 1/1/06 | --- | -5 | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | -5 |
| IV. Additional Tax Relief Provisions | | | | | | | | | | | | | | |
| A. Exclusions of Certain Cancellations of Indebtedness for Certain Taxpayers Affected by Hurricane Katrina | dmo/a 8/25/05 & before 1/1/07 | --- | -190 | -103 | --- | --- | --- | --- | --- | --- | --- | --- | --- | -293 |
| B. Suspend the 10% and $100 Thresholds on Personal Casualty Losses for Losses Which Arise in the Hurricane Katrina Disaster Area | lao/a 8/25/05 | --- | -1,089 | -1,259 | -73 | [23] | --- | --- | --- | --- | --- | --- | --- | -2,420 |
| C. Required Exercise of IRS Administrative Authority | | | | | | | | | | | | | | |
| 1. Required exercise of authority under section 7508A for tax relief for certain taxpayers affected by Hurricane Katrina | DOE | --- | -10 | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | -10 |
| 2. Tax relief under section 7508 by reason of service in a combat zone and under section 7508A for taxpayers affected by natural disasters, terrorist, or military actions | aro/a 8/25/05 | --- | -2 | -2 | -2 | -2 | -2 | -2 | -2 | -2 | -2 | -2 | --- | -20 |
| D. Special Mortgage Financing Rules for Residences Located in Hurricane Katrina Disaster Area | fpb 1/1/08 | --- | -2 | -7 | -14 | -18 | -19 | -19 | -19 | -19 | -19 | -19 | --- | -154 |
| E. Extend Replacement Period for Nonrecognition of Gain for Property Located in Hurricane Katrina Disaster Area | DOE | --- | -837 | -1,151 | -102 | 8 | 15 | 25 | 42 | 53 | 56 | 60 | --- | -1,831 |
| F. Allow Residents of Hurricane Katrina Disaster Area as of August 25, 2005 Who Experienced a Loss of Income Due to Hurricane Katrina to Elect to Use Prior Year's Income in the Calculation of the Earned Income Credit and the Refundable Child Tax Credit [32] | tyi 8/25/05 | --- | -125 | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | -125 |
| G. Secretarial Authority to Make Adjustments Regarding Taxpayer and Dependency Status for Taxpayers Affected by Hurricane Katrina | tybi 2005 or 2006 | *Negligible Revenue Effect* | | | | | | | | | | | | |
| **TOTAL OF PART SEVEN** | | **---** | **-3,319** | **-2,563** | **-193** | **-20** | **-18** | **-14** | **-7** | **5** | **8** | **12** | **---** | **-6,110** |
| **PART EIGHT: THE SPORTFISHING AND RECREATIONAL BOATING SAFETY AMENDMENTS ACT OF 2005 (P.L. 109-74, signed into law by the President on September 29, 2005)** | **DOE** | ***No Revenue Effect*** | | | | | | | | | | | | |
| **PART NINE: THE GULF OPPORTUNITY ZONE ACT OF 2005 (P.L. 109-135, signed into law by the President on December 21, 2005)** | | | | | | | | | | | | | | |
| I. Establishment of the Gulf Opportunity Zone [33] | | | | | | | | | | | | | | |
| A. Tax Benefits for the Gulf Opportunity Zone | | | | | | | | | | | | | | |
| 1. Special allocation of private activity bond financing ($2,500 per capita) | bia DOE & before 1/1/11 | --- | -15 | -51 | -94 | -137 | -181 | -210 | -217 | -217 | -217 | -217 | --- | -1,556 |
| 2. Advance refundings of certain tax-exempt bonds ($7.875 billion of bonds) [34] | ara DOE & before 1/1/11 | --- | -54 | -104 | -119 | -113 | -101 | -89 | -69 | -45 | -29 | -16 | --- | -741 |

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 3. Low-income housing credit (additional credit cap, no carryforward of additional credit cap and other modifications) (sunset 12/31/08) | tyea 8/27/05 | --- | -6 | -29 | -71 | -123 | -149 | -149 | -149 | -149 | -149 | -149 | --- | -1,123 |
| 4. Special allowance for certain property acquired on or after 8/28/05 [35]: | | | | | | | | | | | | | | |
| a. Equipment (sunset 12/31/07) | ppisa 8/27/05 | --- | -785 | -696 | 59 | 355 | 267 | 217 | 163 | 111 | 72 | 43 | --- | -194 |
| b. Structures (sunset 12/31/08) | ppisa 8/27/05 | --- | -542 | -588 | -655 | -259 | -16 | 9 | 31 | 47 | 58 | 64 | --- | -1,850 |
| 5. Increase expensing under section 179 (sunset 12/31/07) [35] | ppisa 8/27/05 | --- | -31 | -27 | -2 | 17 | 12 | 9 | 7 | 5 | 3 | 2 | --- | -7 |
| 6. Partial expensing for certain demolition and clean-up costs (sunset 12/31/07) | apoia 8/27/05 | --- | -84 | -39 | -5 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | --- | -105 |
| 7. Extend and expand to petroleum products expensing for environmental remediation costs (sunset 12/31/07) | Epoia 8/27/05 | --- | -26 | -44 | -15 | 6 | 6 | 7 | 6 | 5 | 4 | 4 | --- | -48 |
| 8. Increase rehabilitation credit (sunset 12/31/08) | Epoia 8/27/05 | --- | -11 | -24 | -21 | -10 | -3 | -2 | -2 | -2 | -1 | -1 | --- | -78 |
| 9. Increase reforestation expensing from $10,000 to $20,000 for expenses incurred in the GO Zone and the Rita GO Zone [36] and Wilma GO Zone (sunset 12/31/07) [37] | potya 10/23/05 | --- | -2 | -1 | [23] | 1 | 1 | 1 | 1 | 1 | [13] | [13] | --- | [23] |
| 10. Treat small timber growers as farmers for purposes of the 5-year NOL carryback in section 172(b)(1)(G) for losses incurred in the GO Zone and the Rita GO Zone [36], and Wilma GO Zone [37] (sunset 12/31/06) | potya 8/27/05 & potya 9/23/05 | --- | -1 | [23] | [13] | [13] | [13] | [13] | [13] | [13] | [13] | [13] | --- | [23] |
| 11. 10-year NOL carryback for certain GO Zone related public utility casualty losses | tyiwelo | --- | -221 | -40 | 39 | 33 | 28 | 24 | 20 | 17 | 15 | 13 | --- | -71 |
| 12. Treatment of net operating losses attributable to GO Zone losses [35] | DOE | --- | -1,003 | -319 | 92 | 166 | 160 | 136 | 115 | 98 | 83 | 71 | --- | -401 |
| 13. Credit to holders of Gulf Tax Credit Bonds | bia 12/31/05 & before 1/1/07 | --- | -7 | -17 | -14 | -3 | -3 | -3 | -3 | -3 | -3 | -3 | --- | -57 |
| 14. Application of New Markets Tax Credit to investments in community development entities serving GO Zone | tyea 8/27/05 | --- | --- | -20 | -43 | -50 | -54 | -59 | -59 | -59 | -36 | -8 | --- | -387 |
| 15. Treatment of representations regarding income eligibility for purposes of qualified residential rental project requirements | DOE | --- | *Negligible Revenue Effect* | | | | | | | | | | | |
| 16. Treatment of public utility property disaster losses | DOE | --- | -128 | -17 | 29 | 23 | 19 | 15 | 12 | 10 | 8 | 6 | --- | -24 |
| 17. Expansion of Hope Scholarship and Lifetime Learning Credits for students in the GO Zone | tyba 12/31/04 & before 1/1/07 | --- | -38 | -17 | --- | --- | --- | --- | --- | --- | --- | --- | --- | -55 |
| 18. Temporary income exclusion of $600 monthly for employer-provided lodging in GO Zone; employer credit of 30% of excluded amount | [38] | --- | -99 | -146 | --- | --- | --- | --- | --- | --- | --- | --- | --- | -246 |
| 19. Extension of special rules for mortgage revenue bonds in the Katrina disaster area | fpb 1/1/11 | --- | --- | --- | -2 | -7 | -11 | -15 | -15 | -15 | -15 | -15 | --- | -96 |
| 20. Special extension of bonus depreciation placed in service date for taxpayers affected by Hurricanes Katrina, Rita and Wilma | DOE | --- | -58 | -18 | 8 | 7 | 6 | 6 | 5 | 5 | 5 | 5 | --- | -29 |
| II. Tax Benefits Related to Hurricanes Rita and Wilma [36] [37] | | | | | | | | | | | | | | |
| A. Special Rules for Use of Retirement Funds for Relief Relating to Hurricanes Rita and Wilma | | | | | | | | | | | | | | |
| 1. Penalty-free withdrawals from retirement plans for qualified Hurricane Rita and Wilma distributions (capped at $100,000 per taxpayer); allow amount of distribution to be repaid to an eligible retirement plan within three years and to be included in income ratably over three years | dma 9/22/05 & dma 10/22/05 & before 1/1/07 | --- | -173 | -41 | 34 | 23 | -5 | -3 | -3 | -2 | -2 | -2 | --- | -174 |
| 2. Recontributions of withdrawals for home purchases cancelled due to Hurricanes Rita and Wilma | dra 2/28/05 & before 9/24/05 & 10/24/05 | --- | *Negligible Revenue Effect* | | | | | | | | | | | |
| 3. Loans from qualified plans to individuals sustaining an economic loss due to Hurricane Rita or Wilma | [39] | --- | *Negligible Revenue Effect* | | | | | | | | | | | |
| B. Employee Retention Credit | | | | | | | | | | | | | | |
| 1. Removal of employer size limitation for Hurricane Katrina employee retention credit | wpoia 8/28/05 & before 1/1/06 | --- | -56 | -18 | -9 | -4 | -2 | --- | --- | --- | --- | --- | --- | -90 |

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2. Employee retention credit for employers of employees affected by Hurricanes Rita and Wilma (no employer size limitation) | wpoia 9/23/05 & wpoia 10/23/05 & before 1/1/06 | --- | -15 | -5 | -3 | -1 | [36] | --- | --- | --- | --- | --- | --- | -24 |
| C. Temporary Suspension of Limitations on Qualified Charitable Contributions for Relief Efforts Related to Hurricane Rita or Wilma | [40] | --- | -85 | 5 | 1 | [23] | [23] | -1 | -3 | -3 | -3 | -3 | --- | -91 |
| D. Suspension of the 10% and $100 Thresholds on Personal Casualty Losses for Losses Which Arise in the Hurricanes Rita and Wilma Disaster Areas | lao/a 9/23/05 & lao/a 10/23/05 | --- | -528 | -611 | -35 | [23] | --- | --- | --- | --- | --- | --- | --- | -1,174 |
| E. Required Exercise of IRS Administrative Authority Under Code Section 7508A for Tax Relief for Certain Taxpayers Affected by Hurricanes Rita, Katrina and Wilma | DOE | --- | *No Revenue Effect* | | | | | | | | | | | |
| F. Special Look-Back Rules for Determining EIC and Refundable Child Credit - allow residents of Rita and Wilma GO Zones (and displaced residents of Hurricanes Rita and Wilma disaster areas) as of September 23, 2005, and October 23, 2005, who experienced a loss of income due to Hurricanes Rita and Wilma to elect to use prior year's income in the calculation of the earned income credit and the refundable child tax credit | tyi 9/23/05 & tyi 10/23/05 | --- | -28 | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | -28 |
| G. Secretarial Authority to Make Adjustments Regarding Taxpayer and Dependency Status | tybi 2005 or 2006 | --- | *Negligible Revenue Effect* | | | | | | | | | | | |
| H. Special Rules for Mortgage Revenue Bonds in the GO Zone, Rita GO Zone, and Wilma GO Zone | fpb 1/1/11 | --- | -1 | -3 | -4 | -5 | -7 | -7 | -7 | -7 | -7 | -7 | --- | -55 |
| III. Other Provisions | | | | | | | | | | | | | | |
| A. Designation of Certain Public Debt as Gulf Coast Recovery Bonds | DOE | --- | *No Revenue Effect* | | | | | | | | | | | |
| B. Election to Include Combat Pay in Earned Income for Purposes of the Earned Income Credit (sunset 12/31/06) | tyba 12/31/05 | --- | --- | -14 | --- | --- | --- | --- | --- | --- | --- | --- | --- | -14 |
| C. Modifications of Suspension of Interest and Penalties Where the IRS Fails to Contact Taxpayer | [41] & dpo/a DOE | --- | 50 | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | 50 |
| D. Authority for Undercover Operations (sunset 12/31/06) | DOE | -- | [13] | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | [13] |
| E. Disclosures of Certain Tax Return Information | | | | | | | | | | | | | | |
| 1. Disclosure of tax return information to facilitate combined employment tax reporting (sunset 12/31/06) | da 12/31/05 | --- | *No Revenue Effect* | | | | | | | | | | | |
| 2. Extension of authority to make disclosures regarding terrorist activities (sunset 12/31/06) | da 12/31/05 | --- | *No Revenue Effect* | | | | | | | | | | | |
| 3. Disclosure of tax return information to carry out administration of income contingent repayment of student loans (sunset 12/31/06) [19] | rma 12/31/05 | --- | *No Revenue Effect* | | | | | | | | | | | |
| IV. Tax Technical Corrections | [42] | --- | *No Revenue Effect* | | | | | | | | | | | |
| **TOTAL OF PART NINE** | | **---** | **-3,947** | **-2,884** | **-830** | **-77** | **-30** | **-111** | **-164** | **-201** | **-211** | **-210** | **---** | **-8,668** |
| **PART TEN: ONE-YEAR EXTENSION OF PARITY IN THE APPLICATION OF CERTAIN LIMITS TO MENTAL HEATH BENEFITS [19] (P.L. 109-151, signed into law by the President on December 30, 2005)** | **bfsfa 12/31/05** | **---** | **-3** | **-45** | **-10** | **---** | **---** | **---** | **---** | **---** | **---** | **---** | **---** | **-58** |

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **PART ELEVEN: THE TAX INCREASE PREVENTION AND RECONCILIATION ACT OF 2005 (P.L. 109-222, signed into law by the President on May 17, 2006)** | | | | | | | | | | | | | | |
| I. Extension and Modification of Certain Provisions | | | | | | | | | | | | | | |
| A. Extension of Increased Expensing for Small Business - increase section 179 expensing from $25,000 to $100,000 and increase the phaseout threshold amount from $200,000 to $400,000; include software in section 179 property; and extend indexing of both the deduction limit and the phaseout threshold (sunset 12/31/09) | tyba 12/31/07 | --- | --- | --- | -2,605 | -4,459 | -209 | 2,707 | 1,772 | 1,222 | 826 | 476 | --- | -271 |
| B. Tax Capital Gains and Dividends With a 15%/0% Rate Structure | | | | | | | | | | | | | | |
| 1. Capital gains (sunset 12/31/10) | tyba 12/31/08 | --- | --- | --- | -1,549 | -8,375 | 2,672 | -54 | -12,698 | [23] | [23] | --- | --- | -20,004 |
| 2. Dividends (sunset 12/31/10) | tyba 12/31/08 | --- | --- | --- | -860 | -4,431 | -8,008 | -9,368 | -6,326 | -1,224 | -450 | -112 | --- | -30,779 |
| C. Controlled Foreign Corporations | | | | | | | | | | | | | | |
| 1. Exception under subpart F for active financing income (sunset 12/31/08) | [43] | --- | --- | -775 | -2,339 | -1,682 | --- | --- | --- | --- | --- | --- | --- | -4,796 |
| 2. Look-through treatment of payments between related CFCs under foreign personal holding company income rules (sunset 12/31/08) | [44] | --- | -82 | -237 | -260 | -167 | --- | --- | --- | --- | --- | --- | --- | -746 |
| II. Other Provisions | | | | | | | | | | | | | | |
| A. Clarification of Taxation of Certain Settlement Funds (sunset 12/31/10) | aafea DOE | --- | -2 | -9 | -10 | -11 | -12 | -13 | -14 | -15 | -15 | -15 | --- | -116 |
| B. Modify Active Business Definition Under Section 355 (sunset 12/31/10) | generally Da DOE | --- | -1 | -7 | -8 | -8 | -9 | -9 | -5 | -3 | -1 | --- | --- | -51 |
| C. Expand the Qualified Veterans' Mortgage Bond Program (sunset 12/31/10) | [45] | --- | [23] | [23] | -1 | -2 | -3 | -5 | -5 | -5 | -5 | -5 | --- | -32 |
| D. Provide Capital Gains Treatment for Certain Self-Created Musical Works (sunset 12/31/10) | soei tyba DOE | --- | --- | -1 | -5 | -5 | -4 | -2 | -4 | --- | --- | --- | --- | -20 |
| E. Expand the Eligibility for the Tonnage Tax Election (minimum of 6,000 deadweight tons) (sunset taxable years ending before 1/1/11) | tyba 12/31/05 | --- | -2 | -3 | -4 | -4 | -4 | -3 | --- | --- | --- | --- | --- | -20 |
| F. Modification of Certain Arbitrage Rule for Certain Funds (include 20% State limitation) (sunset 8/31/09) | bia DOE | --- | --- | --- | -1 | -2 | -1 | [23] | [23] | --- | --- | --- | --- | -5 |
| G. Amortization of Expenses Incurred in Creating or Acquiring Song Rights (sunset 12/31/10) | ppisi tyba 12/31/05 | --- | 1 | 3 | 2 | 1 | -1 | -3 | -6 | -5 | -2 | -3 | --- | -13 |
| H. Modification to Small Issue Bonds - accelerate effective date for increase in capital expenditure limit | bia 12/31/06 | --- | --- | -2 | -9 | -15 | -18 | -18 | -18 | -18 | -18 | -18 | --- | -136 |
| I. Modification of Treatment of Loans to Qualified Continuing Care Facilities (sunset 12/31/10) | [46] | --- | [23] | -3 | -2 | -2 | -2 | -1 | --- | --- | --- | --- | --- | -10 |
| III. Individual AMT Provisions | | | | | | | | | | | | | | |
| A. Extend and Increase Individual AMT Exemption Amount for 2006 to $42,500 ($62,550 Joint) (sunset 12/31/06) | tyba 12/31/05 | --- | -12,419 | -18,628 | --- | --- | --- | --- | --- | --- | --- | --- | --- | -31,047 |
| B. Treatment of Nonrefundable Personal Credits Under the Individual Alternative Minimum Tax (sunset 12/31/06) [47] | tyba 12/31/05 | --- | -565 | -2,260 | --- | --- | --- | --- | --- | --- | --- | --- | --- | -2,825 |
| IV. Corporate Estimated Tax Provisions | | | | | | | | | | | | | | |
| A. Modifications to Corporate Estimated Tax Payments | | | | | | | | | | | | | | |
| 1. Increase corporate estimated tax payments due July through September for corporations with assets in excess of $1 billion in certain years (increase to 105% in 2006, 106.25% in 2012, and 100.75% in 2013 of the otherwise required amount) | DOE | --- | 2,209 | -2,209 | --- | --- | --- | --- | 3,189 | -2,793 | -396 | --- | --- | --- |
| 2. Delay due date until October 1 for a percentage of corporate estimated taxes that are otherwise due on September 15 in certain years (20.5% in 2010 and 27.5% in 2011) | DOE | --- | --- | --- | --- | --- | -5,640 | -2,541 | 8,182 | --- | --- | --- | --- | --- |
| V. Revenue Offset Provisions | | | | | | | | | | | | | | |
| A. Application of Earnings Stripping Rules to Partners Which are Corporations | tybo/a DOE | --- | 2 | 23 | 25 | 27 | 29 | 31 | 33 | 35 | 38 | 41 | --- | 284 |

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| B. Reporting of Interest on Tax-Exempt Bonds | ipa 12/31/05 | --- | [13] | 2 | 2 | 2 | 2 | 3 | 3 | 3 | 3 | 3 | --- | 24 |
| C. 5-Year Amortization of Geological and Geophysical Costs for Major Integrated Oil Companies | apoia DOE | --- | 5 | 28 | 49 | 48 | 30 | 10 | 3 | 4 | 6 | 6 | --- | 189 |
| D. Treatment of Distributions Attributable to FIRPTA Gains (including application of FIRPTA to RICs, and prevention of avoidance through wash sales) [48] | various | --- | 1 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | --- | 28 |
| E. Section 355 Not to Apply to Distributions Involving Disqualified Investment Companies | Da DOE | --- | 2 | 9 | 11 | 12 | 12 | 12 | 12 | 15 | 15 | 16 | --- | 116 |
| F. Loan and Redemption Requirements on Pooled Financings (30% first-year loan origination requirement) | bia DOE | --- | 16 | 35 | 39 | 40 | 42 | 44 | 46 | 49 | 52 | 54 | --- | 417 |
| G. Require Partial Payments With Submissions of Offers-in-Compromise (permanent 24-month rule) | osoaa 60da DOE | --- | --- | 160 | 172 | 185 | 199 | 214 | 230 | 247 | 265 | 285 | --- | 1,955 |
| H. Increase in Age of Minor Children Whose Unearned Income is Taxed as if Parent's Income | tyba 12/31/05 | --- | 56 | 145 | 203 | 219 | 153 | 204 | 242 | 260 | 298 | 349 | --- | 2,128 |
| I. Withholding on Government Payments (including payments under certificate or voucher programs) for Property and Services | pma 12/31/10 | --- | --- | --- | --- | --- | --- | 6,079 | 215 | 220 | 228 | 235 | --- | 6,977 |
| J. Eliminate the Income Limitations on Roth IRA Conversions; Taxpayers Can Elect to Pay Tax on Amounts Converted in 2010 in Equal Installments in 2011 and 2012 | tyba 12/31/09 | --- | --- | --- | --- | -154 | -293 | 2,541 | 4,929 | 1,756 | -1,080 | -1,267 | --- | 6,432 |
| K. Repeal of FSC/ETI Binding Contract Relief | tyba DOE | --- | 6 | 209 | 144 | 72 | 36 | 18 | 9 | 5 | 2 | 1 | --- | 502 |
| L. Modify Wage Limitation for Section 199 to Include Only Wages Allocable to Domestic Production Gross Receipts and Repeal Special Rule Limiting Amount of W-2 Wages Allocated by Pass-Thru Entities | tyba DOE | --- | 1 | 7 | 8 | 9 | 19 | 24 | 26 | 28 | 29 | 31 | --- | 181 |
| M. Amend Section 911 Housing Exclusion and Impose a Stacking Rule and Provide Regulatory Authority to Allow for Geographic Differences | tyba 2005 | --- | 15 | 261 | 199 | 206 | 222 | 228 | 234 | 239 | 254 | 268 | --- | 2,126 |
| N. Tax Involvement of Accommodation Parties in Tax Shelter Transactions | [49] | --- | --- | 18 | 31 | 35 | 40 | 46 | 53 | 62 | 69 | 75 | --- | 428 |
| **TOTAL OF PART ELEVEN** | | **---** | **-10,757** | **-23,231** | **-6,765** | **-18,458** | **-10,745** | **147** | **105** | **85** | **121** | **423** | **---** | **-69,084** |
| **PART TWELVE: THE HEROES EARNED RETIREMENT OPPORTUNITIES ACT - Combat Zone Compensation Taken into Account for Purposes of Determining Limitation and Deductibility of Contributions to Individuals Retirement Plans (P.L. 109-227, signed into law by the President on May 29, 2006)** | **tyba 12/31/03** | **---** | **-1** | **-4** | **-4** | **-6** | **-6** | **-7** | **-7** | **-8** | **-8** | **-9** | **-9** | **-70** |
| **PART THIRTEEN: THE PENSION PROTECTION ACT OF 2006 (P.L. 109-280, signed into law by the President on August 17, 2006)** | | | | | | | | | | | | | | |
| I. Reform of Funding Rules for Single-Employer Defined Benefit Pension Plans | | | | | | | | | | | | | | |
| A. Funding Rules for Single-Employer Defined Benefit Pension Plans [50] | [51] | --- | --- | 1,519 | 2,121 | 910 | 273 | -84 | -779 | -1,685 | -2,126 | -1,690 | -915 | -2,456 |
| B. Benefit Limitations Under Single-Employer Defined Benefit Pension Plans | generally pyba 12/31/07 | --- | --- | *Estimate Included in Item I.1.* | | | | | | | | | | |
| C. Special Rules for Multiple-Employer Plans of Certain Cooperatives | DOE | --- | --- | *Estimate Included in Item I.1.* | | | | | | | | | | |
| D. Temporary Relief for Certain PBGC Settlement Plans | DOE | --- | --- | *Estimate Included in Item I.1.* | | | | | | | | | | |
| E. Special Rules for Plans of Certain Government Contractors | DOE | --- | --- | *Estimate Included in Item I.1.* | | | | | | | | | | |
| F. Modification of Pension Funding Requirement for Plans Subject to Current Transition Rule | pyba 12/31/05 | --- | --- | *Estimate Included in Item I.1.* | | | | | | | | | | |

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| G. Restrictions on Funding of Nonqualified Deferred Compensation Plans by Employers Maintaining Underfunded or Terminated Single-Employer Plans | tooroaa DOE | --- | --- | 7 | 6 | 6 | 6 | 9 | 9 | 8 | 6 | 5 | 3 | 64 |
| II. Funding Rules for Multiemployer Defined Benefit Plans and Related Provisions | | | | | | | | | | | | | | |
| A. Funding Rules for Multiemployer Plans and Additional Funding Rules for Plans in Endangered or Critical Status [53] | pyba 12/31/07 | --- | --- | -1 | -6 | -14 | -22 | -28 | -34 | -41 | -47 | -53 | -59 | -306 |
| B. Measures to Forestall Insolvency of Multiemployer Plans | dmi pyba 12/31/07 | --- | --- | *Estimate Included in Item II.1.* | | | | | | | | | | |
| C. Withdrawal Liability Reforms | various | --- | --- | *Estimate Included in Item II.1.* | | | | | | | | | | |
| D. Procedures Applicable to Withdrawal Liability Disputes | nowlo/a DOE | --- | --- | *Estimate Included in Item II.1.* | | | | | | | | | | |
| E. Prohibition on Retaliation Against Employers Exercising Their Rights to Petition the Federal Government | DOE | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| F. Special Rule for Certain Benefits Funded Under an Agreement Approved by the PBGC | DOE | --- | --- | *Estimate Included in Item II.1.* | | | | | | | | | | |
| G. Exemption From Excise Tax for Certain Plans | DOE | --- | --- | [9] | [9] | [9] | --- | --- | --- | --- | --- | --- | --- | [9] |
| III. Interest Rate Assumptions | | | | | | | | | | | | | | |
| A. Interest Rate Assumption for Lump-Sum Distributions | pyba 12/31/07 | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| B. Interest Rate Assumption for Applying Benefit Limitations to Lump-Sum Distributions | yba 12/31/05 | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| IV. PBGC Guarantee and Related Provisions | | | | | | | | | | | | | | |
| A. PBGC Premiums | generally pyba 12/31/07 & [54] | --- | --- | *Estimate to be Provided by the Congressional Budget Office* | | | | | | | | | | |
| B. Special Funding Rules for Plans Maintained by Commercial Airlines [50] [55] | generally pyea DOE | --- | --- | 55 | 11 | -5 | -7 | -7 | -7 | -7 | -7 | -51 | -81 | -104 |
| C. Limitation on PBGC Guarantee of Shutdown and Other Benefits | [56] | --- | --- | *Estimate to be Provided by the Congressional Budget Office* | | | | | | | | | | |
| D. Rules Relating to Bankruptcy of Employer | [57] | --- | --- | *Estimate to be Provided by the Congressional Budget Office* | | | | | | | | | | |
| E. PBGC Variable Rate Premiums for Small Plans | pyba 12/31/06 | --- | --- | *Estimate to be Provided by the Congressional Budget Office* | | | | | | | | | | |
| F. Authorization for PBGC to Pay Interest on Premium Overpayment Refunds [58] | iafpbnet DOE | --- | --- | -3 | -3 | -3 | -3 | -3 | -3 | -3 | -3 | -3 | -4 | -31 |
| G. Rules for Substantial Owner Benefits in Terminated Plans [58] | [59] | --- | --- | *Negligible Outlay Effect* | | | | | | | | | | |
| H. Acceleration of PBGC Computation of Benefits Attributable to Recoveries From Employers | noitto/a 30da DOE | --- | --- | *Estimate to be Provided by the Congressional Budget Office* | | | | | | | | | | |
| I. Treatment of Certain Plans Where Cessation or Change in Membership of Controlled Group | atosotoo/a DOE | --- | --- | *Estimate to be Provided by the Congressional Budget Office* | | | | | | | | | | |
| J. Missing Participants [58] | dma fripp | --- | --- | *Negligible Outlay Effect* | | | | | | | | | | |
| K. Director of the PBGC | DOE | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| L. Inclusion of Information in the PBGC Annual Report | DOE | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| V. Disclosure | | | | | | | | | | | | | | |
| A. Defined Benefit Plan Funding Notice | pyba 12/31/07 | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| B. Access to Multiemployer Pension Plan Information | pyba 12/31/07 | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| C. Additional Annual Reporting Requirements | pyba 12/31/07 | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| D. Electronic Display of Annual Report Information | pyba 12/31/07 | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| E. Section 4010 Filings With the PBGC | yba 12/31/07 | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| F. Disclosure of Termination Information to Plan Participants | noitta DOE | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| G. Notice of Freedom to Divest Employer Securities | generally pyba 12/31/06 | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| H. Periodic Pension Benefit Statements | generally pyba 12/31/06 | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| I. Notice to Participants or Beneficiaries of Blackout Periods | [60] | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| VI. Investment Advice, Prohibited Transaction, and Fiduciary Rules | | | | | | | | | | | | | | |
| A. Prohibited Transaction Exemption for Provision of Investment Advice | [61] | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| B. Prohibited Transaction Rules Relating to Financial Investments | generally Ta DOE | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| C. Correction Period for Certain Transactions Involving Securities and Commodities | [62] | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| D. Inapplicability of Relief From Fiduciary Liability During Suspension of Ability of Participants or Beneficiary to Direct Investments | pyba 12/31/07 | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| E. Increase in Maximum Bond Amount | pyba 12/31/07 | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| F. Increase in Penalties for Coercive Interference With Exercise of ERISA Rights | voo/a DOE | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| G. Treatment of Investment of Assets by Plan Where Participant Fails to Exercise Investment Election | pyba 12/31/06 | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| H. Clarification of Fiduciary Rules | DOE | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| VII. Benefit Accrual Standards | generally pbo/a 6/29/05 | --- | --- | -10 | -17 | -23 | -31 | -40 | -29 | 7 | 47 | 80 | 94 | 79 |
| VIII. Pension Related Revenue Provisions | | | | | | | | | | | | | | |
| A. Deduction Limitations | [63] | --- | --- | *Estimate Included in Items I. and II.* | | | | | | | | | | |
| B. Certain Pension Provisions Made Permanent | | | | | | | | | | | | | | |
| 1. Permanency of EGTRRA pension and IRA provisions: | | | | | | | | | | | | | | |
| a. EGTRRA pension provisions | generally yba 12/31/10 | --- | --- | --- | --- | --- | --- | -1,856 | -3,038 | -3,321 | -3,675 | -4,097 | -4,471 | -20,460 |
| b. EGTRRA IRA provisions | generally yba 12/31/10 | --- | --- | --- | --- | --- | --- | -786 | -1,819 | -2,384 | -3,002 | -3,589 | -4,157 | -15,737 |
| 2. Permanent extension of the Saver's credit, with indexing of income threshold beginning in 2007 | tyba 12/31/06 | --- | --- | -245 | -989 | -1,010 | -1,014 | -1,071 | -1,142 | -1,147 | -1,163 | -1,153 | -1,142 | -10,076 |
| C. Improvements in Portability, Distribution, and Contribution Rules | | | | | | | | | | | | | | |
| 1. Clarifications regarding purchase of permissive service credit | [64] | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| 2. Rollover of after-tax amounts in annuity contracts | tyba 12/31/06 | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| 3. Clarification of minimum distribution rules to governmental plans | DOE | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| 4. Allow direct rollovers from retirement plans to Roth IRAs | dma 12/31/07 | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| 5. Eligibility for participation in eligible deferred compensation plans | DOE | --- | --- | -1 | -1 | -1 | -1 | -1 | -1 | -2 | -2 | -2 | -2 | -14 |
| 6. Modifications of rules governing hardships and unforeseen financial emergencies | DOE | --- | --- | [13] | [13] | [13] | [13] | [13] | [13] | [13] | [13] | [13] | [13] | [13] |
| 7. Treatment of distributions to reservists called to active duty | dma 9/11/01 | --- | --- | -1 | -1 | -1 | [9] | [9] | [9] | [9] | [9] | [9] | [9] | -5 |
| 8. Inapplicability of 10-percent early withdrawal tax on certain distributions of public safety employees | dma DOE | --- | --- | -2 | -5 | -5 | -5 | -6 | -6 | -7 | -7 | -7 | -8 | -58 |
| 9. Rollovers by nonspouse beneficiaries of certain retirement plan distributions | dma 12/31/06 | --- | --- | -20 | -31 | -37 | -35 | -33 | -31 | -29 | -27 | -24 | -22 | -291 |
| 10. Direct deposit of tax refunds in an IRA | tyba 12/31/06 | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| 11. Allowance of additional IRA payments for certain individuals (sunset taxable years beginning after 12/31/09) | tyba 12/31/06 | --- | --- | -5 | -8 | -6 | -4 | -2 | -2 | -2 | -2 | -2 | -2 | -36 |
| 12. Determination of average compensation for section 415 limits | yba 12/31/05 | --- | --- | [9] | -3 | -5 | -6 | -5 | -5 | -4 | -4 | -4 | -4 | -40 |
| 13. Inflation indexing of certain income limits for IRA contributions | tyba 1/231/06 | --- | --- | -22 | -68 | -106 | -136 | -172 | -212 | -264 | -340 | -415 | -476 | -2,212 |
| D. Health and Medical Benefits | | | | | | | | | | | | | | |
| 1. Use of excess pension assets for future retiree health benefits and collectively bargained retiree health benefits (with 120% threshold) | TA DOE | --- | --- | -23 | -31 | -22 | -15 | -5 | 10 | 13 | 16 | 10 | --- | -47 |
| 2. Transfers of excess pension assets to multiemployer health plans | tmi tyba 12/31/06 | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| 3. Allowance of reserve for medical benefits of plans sponsored by bona fide associations | tyba 12/31/06 | --- | --- | -16 | -27 | -31 | -35 | -40 | -45 | -50 | -56 | -62 | -69 | -430 |
| 4. Treatment of annuity and life insurance contracts with a long-term care insurance feature | [65] | --- | --- | --- | --- | --- | -49 | -239 | -540 | -873 | -1,214 | -1,551 | -1,882 | -6,348 |
| 5. Permit tax-free distributions of up to $3,000 from governmental retirement plans for premiums for health and long-term care insurance for public safety officers | Dmi tyba 12/31/06 | --- | --- | -253 | -245 | -278 | -313 | -340 | -384 | -391 | -398 | -405 | -412 | -3,419 |
| E. United States Tax Court Modernization [66] | generally DOE | --- | --- | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | -1 |

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| F. Other Provisions | | | | | | | | | | | | | | |
| 1. Extension to all governmental plans of current moratorium on application of certain nondiscrimination rules applicable to State and local plans | ybbo/a DOE | --- | --- | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | -1 |
| 2. Eliminate aggregate limit for usage of excess funds from black lung disability trusts to pay for retiree health | tyba 12/31/06 | --- | --- | 9 | 16 | 18 | 10 | 2 | 1 | 1 | 1 | 1 | 1 | 59 |
| 3. Treatment of death benefits from corporate-owned life insurance | generally cia DOE | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| 4. Treatment of test room supervisors and proctors who assist in the administration of college entrance and placement exams | rfspa 12/31/06 | --- | --- | -6 | -4 | -4 | -4 | -4 | -4 | -4 | -4 | -5 | -5 | -45 |
| 5. Grandfather rule for church plans which self-annuitize | DOE | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| 6. Exemption for income from leveraged real estate held by church plans | tybo/a DOE | --- | --- | [9] | [9] | [9] | [9] | [9] | [9] | -1 | -1 | -1 | -1 | -5 |
| 7. Church plan rule for benefit limitations | yba 12/31/06 | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| 8. Gratuitous transfers for the benefit of employees | DOE | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| IX. Increase in Pension Plan Diversification and Participation and Other Pension Provisions | | | | | | | | | | | | | | |
| A. Defined Contribution Plans Required to Provide Employees With Freedom to Invest Their Plan Assets | generally pyba 12/31/06 | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| B. Increase Participation Through Automatic Enrollment Arrangements [67] | generally pyba 12/31/07 & [68] | --- | --- | --- | -139 | -333 | -491 | -615 | -698 | -750 | -800 | -845 | -915 | -5,586 |
| C. Treatment of Eligible Combined Defined Benefit Plans and Qualified Cash or Deferred Arrangements | pyba 12/31/09 | --- | --- | --- | --- | --- | -31 | -78 | -129 | -172 | -216 | -259 | -304 | -1,189 |
| D. Faster Vesting of Employer Nonelective Contributions | generally cf pyba 12/31/06 | --- | --- | -3 | -7 | -7 | -7 | -7 | -8 | -8 | -8 | -8 | -9 | -71 |
| E. Distributions During Working Retirement | Dmi pyba 12/31/06 | --- | --- | 3 | 9 | 19 | 28 | 32 | 33 | 33 | 32 | 32 | 32 | 255 |
| F. Treatment of Certain Pension Plans of Indian Tribal Governments | ybo/a DOE | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| X. Provisions Relating to Spousal Pension Protection | | | | | | | | | | | | | | |
| A. Regulations on Time and Order of Issuance of Domestic Relations Orders | DOE | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| B. Entitlement of Divorced Spouses to Railroad Retirement Annuities Independent of Actual Entitlement of Employee [58] | 1ya DOE | --- | --- | *Negligible Outlay Effect* | | | | | | | | | | |
| C. Extension of Tier II Railroad Retirement Benefits to Surviving Former Spouses Pursuant to Divorce Agreements [58] | 1ya DOE | --- | --- | [9] | [9] | -1 | -1 | -1 | -1 | -2 | -2 | -2 | -3 | -12 |
| D. Requirement for Additional Survivor Annuity Option | generally pyba 12/31/07 | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| XI. Administrative Provisions | | | | | | | | | | | | | | |
| A. Updating of Employee Plan Compliance Resolution System | DOE | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| B. Notice and Consent Period Regarding Distributions | yba 12/31/06 | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| C. Pension Plan Reporting Simplification | pybo/a 1/1/07 & DOE | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| D. Voluntary Early Retirement Incentive and Employment Retention Plans Maintained by Local Educational Agencies and Other Entities | generally DOE | --- | --- | -1 | -1 | -4 | -10 | -14 | -16 | -14 | -12 | -9 | -7 | -87 |
| E. No Reduction in Unemployment Compensation as a Result of Pension Rollovers [70] | wbo/a DOE | --- | --- | -15 | -24 | -29 | -20 | -12 | -6 | -2 | [9] | 1 | [13] | -107 |
| F. Revocation of Election to be Treated as Multiemployer Plan | DOE | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| G. Provisions Relating to Plan Amendments | DOE | --- | --- | *Estimate Included in the Provision to Which the Change Relates* | | | | | | | | | | |
| XII. Provisions Relating to Exempt Organizations | | | | | | | | | | | | | | |
| A. Charitable Giving Incentives | | | | | | | | | | | | | | |
| 1. Tax-free distributions from IRAs to certain public charities from age 70 1/2 or older, not to exceed $100,000 per taxpayer per year; modify return requirements of split-interest trusts | tyba 12/31/05 & tybb 1/1/08; rf tyba 12/31/06 | --- | --- | -238 | -93 | -36 | -44 | -60 | -73 | -74 | -78 | -79 | -81 | -856 |

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2. Extend and modify present-law special rule for enhanced deduction for food inventory | cma 12/31/05 & before 1/1/08 | --- | --- | -68 | -100 | -83 | --- | --- | --- | --- | --- | --- | --- | -251 |
| 3. Adjustment to basis of S corporation stock for certain charitable contributions | cmi tyba 12/31/05 & tybb 1/1/08 | --- | --- | -49 | -20 | -5 | -5 | -5 | -5 | -5 | -5 | -5 | -5 | -109 |
| 4. Extend and modify present-law special rule for enhanced deduction for book inventory to public schools | cma 12/31/05 & before 1/1/08 | --- | --- | -27 | -10 | --- | --- | --- | --- | --- | --- | --- | --- | -37 |
| 5. Modify tax treatment of certain payments under existing arrangements to controlling exempt organizations; require reporting regarding controlled organizations and a Treasury study | [71] | --- | --- | -32 | -6 | --- | --- | --- | --- | --- | --- | --- | --- | -38 |
| 6. Encourage contributions of property interests made for conservation purposes | cmi tyba 12/31/05 & tybb 1/1/08 | --- | --- | -33 | -18 | -5 | --- | --- | --- | --- | --- | --- | --- | -56 |
| 7. Federal excise tax exemptions for blood collector organizations | [72] | --- | --- | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -12 |
| B. Reforming Exempt Organizations | | | | | | | | | | | | | | |
| 1. Temporarily require reporting of certain acquisitions of interests in insurance contracts in which certain exempt organizations hold an interest; require Treasury study | generally DOE & [73] | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| 2. Increase penalty excise taxes relating to public charities, social welfare organizations, and private foundations | tyba DOE | --- | --- | 6 | 7 | 7 | 6 | 6 | 7 | 7 | 7 | 8 | 8 | 69 |
| 3. Limitations of charitable donations of easements in registered historic districts and reduction of deduction to take account of any rehabilitation credit | generally cma 7/25/06 | --- | --- | 3 | 5 | 7 | 8 | 8 | 8 | 8 | 9 | 9 | 9 | 72 |
| 4. Modification of rules regarding donation of self-created taxidermy and exempt use property | [74] | --- | --- | 2 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 6 | 6 | 49 |
| 5. Allow deduction for charitable contributions of clothing and household items only if in good used condition or better, and increased substantiation required for charitable contributions (receipts for all cash gifts) | cma DOE & cmi tyba DOE | --- | --- | 12 | 49 | 50 | 51 | 52 | 52 | 52 | 53 | 54 | 55 | 480 |
| 6. Modification of rules regarding donations of fractional interests in tangible personal property | cbagma DOE | --- | --- | 4 | 6 | 6 | 6 | 6 | 7 | 7 | 7 | 7 | 7 | 63 |
| 7. Provisions relating to appraisers and substantial and gross overstatement of valuations of property: | | | | | | | | | | | | | | |
| a. Substantial and gross overstatements of valuations of property | rfa DOE & [75] | --- | --- | 2 | 2 | 2 | 2 | 2 | 2 | 3 | 4 | 4 | 5 | 28 |
| b. Penalty on appraisers whose appraisals result in substantial or gross valuation misstatements | rfa DOE & [75] | --- | --- | [13] | [13] | [13] | [13] | [13] | [13] | [13] | [13] | [13] | [13] | 3 |
| 8. Establish additional exemption standards for credit counseling organizations | generally tyba DOE | --- | --- | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 54 |
| 9. Expand the base of the tax on private foundation net investment income | tyba DOE | --- | --- | 19 | 19 | 20 | 20 | 21 | 22 | 23 | 24 | 25 | 25 | 218 |
| 10. Definition of convention or association of churches | DOE | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| 11. Notification requirement for exempt entities not currently required to file an annual information return | fapba 12/31/06 | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| 12. Disclosure to State officials of tax information related to section 501(c) organizations | DOE | --- | --- | *Negligible Revenue Effect* | | | | | | | | | | |
| 13. Require that Form 990-T of section 501(c)(3) organizations be made publicly available | tyba DOE | --- | --- | [13] | [13] | [13] | [13] | [13] | [13] | [13] | [13] | [13] | [13] | 9 |
| 14. Treasury study of donor advised funds and supporting organizations | DOE | --- | --- | *No Revenue Effect* | | | | | | | | | | |
| 15. Define donor advised fund and, in general, provide rules relating to excess business holdings and certain prohibited transactions [76] | generally tyba DOE | --- | --- | 1 | 1 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 17 |
| 16. Provide for prohibited transactions and additional reporting by all supporting organizations, limit business holdings, and improve accountability of Type III supporting organizations [77] | generally DOE | --- | --- | 4 | 4 | 5 | 5 | 5 | 6 | 6 | 6 | 7 | 7 | 56 |

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| XIII. Other Provisions | | | | | | | | | | | | | | |
| A. Exception From Local Furnishing Requirements for Certain Bonds Issued Before 5/31/06 | DOE | --- | --- | [9] | -1 | -2 | -2 | -2 | -2 | -2 | -2 | -2 | -2 | -18 |
| B. Permanently Extend the Enhanced Education Savings Provisions Under Section 529, With Regulatory Authority to Prevent Abuses | DOE | --- | --- | --- | --- | --- | --- | -273 | -583 | -660 | -748 | -847 | -959 | -4,071 |
| **TOTAL OF PART THIRTEEN** | | **---** | **---** | **572** | **404** | **-997** | **-1,866** | **-5,635** | **-9,433** | **-11,723** | **-13,723** | **-14,911** | **-15,734** | **-73,047** |
| **PART FOURTEEN: TAX RELIEF AND HEALTH CARE ACT OF 2006 (P.L. 109-432, signed into law by the President on December 20, 2006)** | | | | | | | | | | | | | | |
| **Division A:** | | | | | | | | | | | | | | |
| I. Extension and Modification of Certain Provisions | | | | | | | | | | | | | | |
| A. Deduction for Qualified Tuition and Related Expenses (sunset 12/31/07) | tyba 12/31/05 | --- | --- | -1,621 | -1,671 | --- | --- | --- | --- | --- | --- | --- | --- | -3,292 |
| B. Extend and Modify the New Markets Tax Credit (sunset 12/31/08) | DOE | --- | --- | --- | -106 | -168 | -170 | -192 | -205 | -202 | -202 | -77 | --- | -1,322 |
| C. Deduction of State and Local General Sales Taxes (sunset 12/31/07) | tyba 12/31/05 | --- | --- | -2,985 | -2,145 | -401 | --- | --- | --- | --- | --- | --- | --- | -5,531 |
| D. Extend and Modify the Research Credit (sunset 12/31/07) [83] | apoia 12/31/05 & tyea 12/31/06 | --- | --- | -7,520 | -4,168 | -2,204 | -1,583 | -858 | -188 | --- | --- | --- | --- | -16,522 |
| E. Extend Current Work Opportunity Tax Credit and Welfare-to-Work Tax Credit for 2006; and Combine the Two Credits and Modify the Food-Stamp Recipient and Ex-Felon Categories for 2007 (sunset 12/31/07) | wpoifibwa 12/31/05 | --- | --- | -392 | -317 | -155 | -73 | -42 | -19 | -4 | [9] | --- | --- | -1,002 |
| F. Extend Election to Include Combat Pay in Earned Income for Purposes of the Earned Income Credit (sunset 12/31/07) | tyba 12/31/06 | --- | --- | --- | -12 | --- | --- | --- | --- | --- | --- | --- | --- | -12 |
| G. Extend and Modify Qualified Zone Academy Bonds (arbitrage restrictions and spending requirements) (sunset 12/31/07) | oia 12/31/05 & [84] | --- | --- | -7 | -17 | -30 | -38 | -40 | -40 | -40 | -40 | -40 | -40 | -330 |
| H. Above-the-Line Deduction of up to $250 for Teacher Classroom Expenses (sunset 12/31/07) | epoii tyba 12/31/05 | --- | --- | -226 | -153 | --- | --- | --- | --- | --- | --- | --- | --- | -379 |
| I. Extend and Expand to Petroleum Products the Expensing of "Brownfields" Environmental Remediation Costs (sunset 12/31/07) | Epoia 12/31/05 | --- | --- | -557 | -123 | 44 | 52 | 53 | 47 | 42 | 36 | 30 | 27 | -349 |
| J. Tax Incentives for Investment in the District of Columbia (sunset 12/31/07) | tyba 12/31/05 | --- | --- | -96 | -24 | -5 | -9 | -16 | -48 | -70 | -46 | -41 | -36 | -392 |
| K. Indian Employment Tax Credit (sunset 12/31/07) | tyba 12/31/05 | --- | --- | -67 | -38 | -10 | -1 | --- | --- | --- | --- | --- | --- | -117 |
| L. Accelerated Depreciation for Business Property on Indian Reservations (sunset 12/31/07) | ppisa 12/31/05 | --- | --- | -465 | -301 | -65 | 76 | 152 | 169 | 117 | 46 | -3 | -13 | -288 |
| M. 15-Year Straight-Line Cost Recovery for Qualified Leasehold Improvements and Qualified Restaurant Property (sunset 12/31/07) | ppisa 12/31/05 | --- | --- | -394 | -536 | -600 | -588 | -560 | -527 | -524 | -529 | -514 | -453 | -5,225 |
| N. Increase in Limit on Cover Over of Rum Excise Tax Revenues (from $10.50 to $13.25 per proof gallon) to Puerto Rico and the Virgin Islands (sunset 12/31/07) [85] | abiUSa 12/31/05 | --- | --- | -165 | -19 | --- | --- | --- | --- | --- | --- | --- | --- | -184 |
| O. Parity in the Application of Certain Limits to Mental Health Benefits (sunset 12/31/07) [86] | DOE | --- | --- | -5 | -25 | -5 | --- | --- | --- | --- | --- | --- | --- | -35 |
| P. Charitable Contributions of Scientific and Computer Property | | | | | | | | | | | | | | |
| 1. Expand charitable contribution allowed for scientific property used for research and for computer technology and equipment to include property assembled by the taxpayer [87] | tyba 12/31/05 | --- | --- | -33 | -20 | -5 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -65 |

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2. Extend enhanced deduction for qualified computer contributions (sunset for taxable years beginning after 12/31/07) | cmd tyba 12/31/05 | --- | --- | -136 | -68 | -11 | --- | --- | --- | --- | --- | --- | --- | -215 |
| Q. Availability of Medical Savings Accounts (sunset 12/31/07) | DOE | *Negligible Revenue Effect* | | | | | | | | | | | | |
| R. Suspension of 100 Percent-of-Net-Income Limitation on Percentage Depletion for Oil and Natural Gas from Marginal Properties (sunset 12/31/07) | tyba 12/31/05 | --- | --- | -146 | -30 | --- | --- | --- | --- | --- | --- | --- | --- | -176 |
| S. Economic Development Credit for American Samoa (sunset taxable years beginning after 12/31/07) | tyba 12/31/05 | --- | --- | -17 | -8 | --- | --- | --- | --- | --- | --- | --- | --- | -25 |
| T. Extend Placed-in-Service Date Requirement to 12/31/10 for Nonresidential Real and Residential Rental Property That Qualifies for GO Zone Bonus Depreciation for Counties or Parishes in Which Greater Than 60 Percent of the Housing Units were Damaged by Hurricanes in 2005, Limited to Progress Expenditures Made Prior to 1/1/10; Include Certain Other Bonus Depreciation Property Placed in Service in Qualified GO Zone Extension Property | [88] | --- | --- | --- | -28 | -194 | -238 | -80 | 5 | 13 | 17 | 19 | 20 | -465 |
| U. Authority for Undercover Operations (sunset 12/31/07) | DOE | --- | --- | [13] | --- | --- | --- | --- | --- | --- | --- | --- | --- | [13] |
| V. Disclosures of Certain Tax Return Information | | | | | | | | | | | | | | |
| 1. Extend disclosure of tax return information to facilitate combined employment tax reporting (sunset 12/31/07) | da 12/31/06 | *No Revenue Effect* | | | | | | | | | | | | |
| 2. Extend authority to make disclosures regarding terrorist activities (sunset 12/31/07) | da 12/31/06 | *No Revenue Effect* | | | | | | | | | | | | |
| 3. Extend disclosure of tax return information to carry out administration of income contingent repayment of student loans (sunset 12/31/07) [86] | rma 12/31/06 | *No Revenue Effect* | | | | | | | | | | | | |
| II. Energy Tax Provisions | | | | | | | | | | | | | | |
| A. Credit for Electricity Produced From Certain Renewable Resources - Extend Placed-in-Service Date for Tax Credit for Electricity Produced at Wind, Closed-Loop Biomass, Open-Loop Biomass, Geothermal Energy, Small Irrigation Power, Landfill Gas, Trash Combustion, or Qualified Hydropower Facilities (sunset 12/31/08) | fpisa 12/31/07 | --- | --- | --- | -95 | -263 | -345 | -365 | -373 | -367 | -358 | -361 | -363 | -2,893 |
| B. Clean Renewable Energy Bonds ($400 million additional issuance authority through 12/31/08) | bia 12/31/06 | --- | --- | --- | -7 | -18 | -24 | -24 | -23 | -22 | -20 | -19 | -17 | -174 |
| C. Modification of Advanced Coal Credit With Respect to Subbituminous Coal | casa 10/2/06 | *No Revenue Effect* | | | | | | | | | | | | |
| D. Allowance of Deduction for Certain Energy Efficient Commercial Building Property (sunset 12/31/08) | ppisa 12/31/07 | --- | --- | --- | -117 | -61 | 4 | 4 | 3 | 3 | 2 | 2 | 2 | -159 |
| E. Credit for Construction of New Energy Efficient Homes (sunset 12/31/08) | hpa 12/31/07 | --- | --- | --- | -20 | -15 | -5 | -5 | -4 | -4 | -3 | -1 | --- | -56 |
| F. 30% Credit for Residential Purchases/Installations of Solar (electric and hot water) and Fuel Cells (sunset 12/31/08) | ppisa 12/31/07 | --- | --- | --- | -7 | -29 | --- | --- | --- | --- | --- | --- | --- | -37 |
| G. Energy Credit Provisions | | | | | | | | | | | | | | |
| 1. Business solar investment tax credit (generally sunset 12/31/08) | [89] | --- | --- | --- | -38 | -13 | -6 | -6 | -3 | [13] | [13] | [13] | 1 | -65 |
| 2. Credit for business installation of qualified fuel cells and stationary microturbine power plants (sunset 12/31/08) | [90] | *Estimate Contained in Item Above* | | | | | | | | | | | | |
| H. Special Rule for Qualified Methanol or Ethanol Fuel Produced from Coal (sunset 12/31/08) | 10/1/07 | --- | --- | --- | [9] | [9] | --- | --- | --- | --- | --- | --- | --- | [9] |
| I. Special Depreciation Allowance for Cellulosic Biomass Ethanol Plant Property (sunset 12/31/12) | [91] | --- | --- | --- | -1 | -5 | -5 | -7 | -12 | --- | 8 | 6 | 5 | -9 |
| J. Expenditures Permitted from the Leaking Underground Storage Tank Trust Fund [92] | DOE | *No Revenue Effect* | | | | | | | | | | | | |

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| K. Section 45K as Applied to Coke - Repeal Phaseout of the Coke Credit and Clarify That Petroleum Coke Does Not Qualify for the Credit | [93] | --- | --- | --- | --- | --- | --- | *No Revenue Effect* | --- | --- | --- | --- | --- | --- |
| III. Health Savings Accounts Provisions | | | | | | | | | | | | | | |
| A. Allow a One-Time Rollover of HRA and Health FSA Funds into an HSA (sunset for taxable years beginning after 12/31/11) [94] | do/a DOE | --- | --- | -2 | -4 | -4 | -4 | -5 | -2 | --- | --- | --- | --- | -21 |
| B. Disregard Grace Period Health FSA Coverage for Purposes of Eligibility for Deductible HSA Contributions if FSA has Zero Balance at End of Prior Plan Year or Remaining Balance from Prior Plan Year is Transferred to an HSA | [95] | --- | --- | --- | --- | --- | --- | *Negligible Revenue Effect* | --- | --- | --- | --- | --- | --- |
| C. Repeal the Limitation on HSA Contributions That Corresponds to the Annual Deductible Under the High-Deductible Insurance Policy [96] | tyba 12/31/06 | --- | --- | -10 | -17 | -27 | -30 | -38 | -50 | -66 | -115 | -170 | -190 | -712 |
| D. Compute Cost-of-Living Adjustments for HSA Provisions Earlier in the Calendar Year (March in lieu of August) | afya 2007 | --- | --- | --- | --- | --- | --- | *Negligible Revenue Effect* | --- | --- | --- | --- | --- | --- |
| E. Allow Full Deductible Contribution for Months Preceding Month That Taxpayer is in High Deductible Plan | tyba 12/31/06 | --- | --- | -11 | -29 | -33 | -36 | -37 | -37 | -35 | -33 | -28 | -22 | -302 |
| F. Modify Comparability Rules so That Employers May Make Larger Contributions to HSAs of Non-Highly Compensated Employees Than to HSAs of Highly Compensated Employees | tyba 12/31/06 | --- | --- | --- | --- | --- | --- | *Negligible Revenue Effect* | --- | --- | --- | --- | --- | --- |
| G. Allow a One-Time Rollover of IRA Funds to an HSA [97] | tyba 12/31/06 | --- | --- | --- | --- | --- | --- | *Negligible Revenue Effect* | --- | --- | --- | --- | --- | --- |
| IV. Other Tax Provisions | | | | | | | | | | | | | | |
| A. Expand Section 199 Manufacturing Deduction to Puerto Rico (sunset after two taxable years) | tyba 2005 | --- | --- | -107 | -55 | --- | --- | --- | --- | --- | --- | --- | --- | -162 |
| B. Refundable Long-Term Individual AMT Credits (phased out using PEP phase out) (sunset 12/31/12); Stock Option Reporting [98] | tyba DOE & cyba DOE | --- | --- | -417 | -519 | -373 | -245 | -134 | -30 | 274 | 455 | 464 | 474 | -51 |
| C. Partial Expensing for Advanced Mine Safety Equipment (sunset for property placed in service after 12/31/08) | cpoia DOE | --- | --- | -14 | -18 | 1 | 8 | 6 | 5 | 4 | 4 | 2 | 1 | -1 |
| D. Mine Rescue Team Training Credit (sunset 12/31/08) | tyba 12/31/05 | --- | --- | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -9 |
| E. Whistleblower Reforms (above-the-line deduction for costs) [99] | ipo/a DOE | --- | --- | 2 | 3 | 7 | 11 | 15 | 20 | 25 | 30 | 33 | 36 | 182 |
| F. Frivolous Tax Submissions | [100] | --- | --- | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 30 |
| G. Addition of Certain Vaccines to the List of Taxable Vaccines | | | | | | | | | | | | | | |
| 1. Permanently add the meningococcal vaccine to the list of taxable vaccines [101] | 1ma DOE | --- | --- | 1 | [102] | [102] | [102] | [102] | [102] | -1 | -1 | -1 | -1 | -5 |
| 2. Permanently add the vaccine against human papillomavirus ("HPV") to list of taxable vaccines [101] | 1ma DOE | --- | --- | 2 | 2 | 2 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 12 |
| H. Clarification of Taxation of Certain Settlement Funds Made Permanent | [103] | --- | --- | --- | --- | --- | --- | -2 | -5 | -8 | -9 | -10 | -11 | -45 |
| I. Modification of Active Business Definition Under Section 355 Made Permanent | [103] | --- | --- | --- | --- | --- | --- | -2 | -7 | -11 | -15 | -17 | -19 | -71 |
| J. Revision of the Qualified Veterans' Mortgage Bond Program Made Permanent | [103] | --- | --- | --- | --- | --- | --- | [9] | -1 | -2 | -4 | -5 | -6 | -19 |
| K. Capital Gains Treatment for Certain Self-Created Musical Works Made Permanent | [103] | --- | --- | --- | --- | --- | [9] | -2 | -2 | -6 | -6 | -6 | -7 | -29 |
| L. Reduction in Minimum Vessel Tonnage Limit to 6,000 Deadweight Tons Made Permanent | [103] | --- | --- | --- | --- | --- | --- | -3 | -15 | -18 | -21 | -24 | -27 | -108 |
| M. Modification of Special Arbitrage Rules for Certain Funds (20% State limitation) Made Permanent | [103] | --- | --- | --- | --- | [9] | -1 | -2 | -2 | -3 | -3 | -4 | -5 | -20 |
| N. Great Lakes Domestic Shipping to Not Disqualify Vessel From Tonnage Tax | tyba DOE | --- | --- | -2 | -4 | -4 | -5 | -5 | -6 | -6 | -6 | -7 | -7 | -52 |
| O. Expand the Qualified Mortgage Bond Program (waive first-time homebuyer requirement for veterans; restrict to one exemption per person) | bia DOE & before 1/1/08 | --- | --- | -16 | -30 | -37 | -37 | -37 | -37 | -37 | -37 | -37 | -37 | -339 |

| Provision | Effective | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2005-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| P. Exclusion of Gain From Sale of a Principal Residence by Certain Employees of the Intelligence Community (sunset 12/31/10) | soea DOE | --- | --- | [9] | [9] | [9] | [9] | [9] | --- | --- | --- | --- | --- | -1 |
| Q. Nonrecognition of Capital Gains for Federal Judges Who Sell Property to Avoid Conflicts of Interest | sa DOE | --- | --- | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | -3 |
| R. Establish Deduction for Private Mortgage Insurance (sunset 12/31/07) | apoaa 12/31/06 | --- | --- | -14 | -77 | --- | --- | --- | --- | --- | --- | --- | --- | -91 |
| S. Modification of Refunds for Kerosene Used in Aviation | [104] | --- | --- | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] |
| T. Regional Income Tax Agencies Treated as States for Purposes of Confidentiality and Disclosure Requirements | Dma 12/31/06 | --- | --- | --- | --- | --- | --- | *No Revenue Effect* | --- | --- | --- | --- | --- | --- |
| U. Limit the Use of Names on Certain Wines Sold in the United States | wiobiUSo/a DOE | --- | --- | --- | --- | --- | --- | *No Revenue Effect* | --- | --- | --- | --- | --- | --- |
| V. Treat Reimbursed Amounts as Eligible for Railroad Track Maintenance Credit | tyba 12/31/04 & before 1/1/08 | --- | --- | -22 | -27 | [9] | --- | --- | --- | --- | --- | --- | --- | -49 |
| W. Modify Excise Tax on Unrelated Business Taxable Income of Charitable Remainder Trusts | tyba 12/31/06 | --- | --- | --- | -3 | -6 | -7 | -7 | -7 | -8 | -8 | -8 | -8 | -62 |
| X. Special Rule Regarding Treatment of Loans to Qualified Continuing Care Facilities Made Permanent | [103] | --- | --- | --- | --- | --- | --- | -1 | -2 | -2 | -2 | -3 | -3 | -14 |
| Y. Tax Technical Corrections | | | | | | | | | | | | | | |
| 1. Technical correction relating to TIPRA CFC look-through | [105] | --- | --- | --- | --- | --- | --- | *No Revenue Effect* | --- | --- | --- | --- | --- | --- |
| 2. Modification of exception from interest suspension rules for certain listed and reportable transactions | [106] | --- | --- | --- | --- | --- | --- | *No Revenue Effect* | --- | --- | --- | --- | --- | --- |
| **Division C:** | | | | | | | | | | | | | | |
| V. Miscellaneous Provisions | | | | | | | | | | | | | | |
| A. Surface Mining Control and Reclamation Act Amendments of 2006 [86] [107] | generally DOE | --- | --- | -10 | -290 | -330 | -450 | -490 | -530 | -570 | -540 | -330 | -340 | -3,880 |
| B. Clarify That the Personal Use Exemption for Tobacco Products Does Not Apply to Delivery Sales [108] | 15da DOE | --- | --- | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 9 |
| C. Provide a 25% Exclusion From Income for Certain Conservation Sales of Mineral or Geothermal Interests on Eligible Federal Land | soo/a DOE | --- | --- | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | [9] | -1 |
| D. Tax Court Review of Requests for Equitable Relief From Joint and Several Liability | taoruo/a DOE | --- | --- | --- | --- | --- | --- | *Negligible Revenue Effect* | --- | --- | --- | --- | --- | --- |
| **TOTAL OF PART FOURTEEN** | | **---** | **---** | **-15,449** | **-11,159** | **-5,014** | **-3,746** | **-2,727** | **-1,923** | **-1,525** | **-1,397** | **-1,147** | **-1,036** | **-45,133** |
| **PART FIFTEEN: FALLEN FIREFIGHTERS ASSISTANCE TAX CLARIFICATION ACT OF 2006 - Payments by Certain Charitable Organizations for the Benefit of Firefighters Who Died as a Result of the Esperanza Fire Treated as Exempt Payments (P.L. 109-445, signed into law by the President on December 21, 2006)** | **pmo/a 10/26/06 & before 1/1/07** | **---** | **[9]** | **---** | **---** | **---** | **---** | **---** | **---** | **---** | **---** | **---** | **---** | **[9]** |

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

*[Legend and Footnotes for the Appendix appear on the following page]*

**Legend and Footnotes for the Appendix:**

Legend for "Effective" column:

aafea = accounts and funds established after
abiUSa = articles brought into the United States after
afya = adjustments for years after
aoftaa = actions, or failures to act, after
apa = appliances produced after
apoaa = amounts paid or accrued after
apoia = amounts paid or incurred after
apoii = amounts paid or incurred in
ara = advance refundings after
arbo/a = amounts received before, on, or after
aro/a = actions required on or after
atosotoo/a = any transaction or series of transactions occurring on or after
bia = bonds issued after
boaa = before, on, and after
bfsfa = benefits for services furnished after
casa = certification applications submitted after
cbagma = contributions, bequests, and gifts made after
cf = contributions for
cia = contracts issued after
cma = contributions made after
cmd = contributions made during
cmi = contributions made in
cmo/a = contributions made on or after
cpoia = costs paid or incurred after
cyba = calendar years beginning after
da = disclosures after
Da = distributions after
dma = distributions made after
Dma = disclosures made after
dmi = determinations made in
Dmi = distributions made in
dmo/a = discharges made on or after
do/a = distributions on or after
DOE = date of enactment
dopa = dispositions of property after
dpo/a = documents provided on or after
dra = distributions received after
epoia = expenses paid or incurred after
Epoia = expenditures paid or incurred after
epoii = expenses paid or incurred in
fapba = for annual periods beginning after
fpb = financing provided before
fpisa = facilities placed in service after
freosa = fuel removed, entered or sold after
fripp = final regulations implementing the provision are prescribed
fsoua = fuel sold or used after
fuoata = fuel use or air transportation after
hpa = homes purchased after
iafpbnet = interest accruing for periods beginning not earlier than
ipa = interest paid after
ipo/a = information provided on or after
lao/a = losses arising on or after
noitta = notice of intent to terminate after
noitto/a = notice of intent to terminate on or after
nowlo/a = notification of withdrawal liability on or after
oia = obligations issued after
osoaa = offers submitted on and after
pa = periods after
pbo/a = periods beginning on or after
pma = payments made after
pmo/a = payments made on or after
potya = portion of taxable year after
ppisa = property placed in service after
ppisi = property placed in service in
pyba = plan years beginning after
pybo/a = plan years beginning on or after
pyea = plan years ending after
qpboaa = quarterly periods beginning on and after
rf = returns for
rfa = returns filed after
rma = requests made after
rfspa = remuneration for services performed after
sa = sales after
soei = sales or exchanges in
soo/a = sales occurring on or after
suora = sale, use or removal after
ta = transportation after
Ta = transactions after
TA = transfers after
tmi = transfers made in
tooroaa = transfers or other reservations of assets after
tsohofsoa = transfer, sale, or holding out for sale occurring after
taoruo/a = taxes arising or remaining unpaid on or after
tyba = taxable years beginning after
tybb = taxable years beginning before
tybi = taxable years beginning in
tybo/a = taxable years beginning on or after
tyea = taxable years ending after
tyi = taxable years including
tyiwelo = taxable years in which eligible losses occur
uopao/a = use of passenger automobile on or after
voo/a = violations occurring on or after
wbo/a = weeks beginning on or after
wiobiUSo/a = wine imported or bottled in the United States on or after
wpoia = wages paid or incurred after
wpoifibwa = wages paid or incurred for individuals beginning work after
wpoio/a = wages paid or incurred on or after
yba = years beginning after
ybbo/a = years beginning before, on, or after
ybo/a = years beginning on or after
30da = 30 days after
15da = 15 days after
60da = 60 days after
1ma = one month after
1ya = 1 year after

[1] Estimate includes interaction effect with the clean renewable energy bond provision (Part Five, item A.2.).
[2] Subject to rules similar to those of section 48(m) (as in effect before its repeal).
[3] Excluding assets subject to binding contracts entered into on or before April 11, 2005, and restricted to original-use property.
[4] Effective for net operating losses generated in tax years ending in 2003, 2004, and 2005.
[5] Effective for credits earned after December 31, 2005. No carryback of unused credit for taxes paid prior to January 1, 2006.
[6] Excluding assets subject to binding contracts entered into on or before June 14, 2005, and restricted to original-use property.
[7] Effective as if included in the American Jobs Creation Act of 2004.
[8] Loss of less than $1 million.
[9] Loss of less than $500,000.
[10] Estimate is based upon proposed Energy Star standards for 2007.
[11] Effective for periods after December 31, 2005, and before January 1, 2008, for property placed in service in taxable years ending after December 31, 2005.
[12] Effective for periods after December 31, 2005 (and before January 1, 2008 in the case of the 30 percent credit and fiber optic distributed sunlight), for property placed in service in taxable years ending after December 31, 2005.
[13] Gain of less than $500,000.
[14] Estimate assumes an emulsion percentage of at least 14 percent water.
[15] The tax applies on April 1, 2006, or if later, the date which is 30 days after the last day of any calendar quarter for which the Secretary estimates that, as of the close of that quarter, the unobligated balance in the Oil Spill Liability Trust fund is less than $2 billion.
[16] Effective as if included in section 869 of the American Jobs Creation Act of 2004.

*[Footnotes for the Appendix are continued on the following page]*

**Footnotes for the Appendix continued:**

[17] The Act allows the present-law expiration of the general fund retention of the 4.8 cents per gallon of taxes on gasoline and special motor fuels used in motorboats and in the non-business use of small-engine outdoor power equipment. Because the Congressional Budget Office ("CBO") baseline assumes the general fund retention of the 4.8 cents per gallon tax will not expire, the conference agreement provision is scored by CBO as a reduction in receipts to the general fund and an increase in receipts to the Sport Fish Restoration and Boating Trust Fund. The increases in receipts to the Sport Fish Restoration and Boating Trust Fund trigger an increase in outlays, which are estimated by CBO to be $1,061 million for fiscal years 2005 through 2015.
[18] The credit generally expires September 30, 2009. However, for liquefied hydrogen, the credit expires after September 30, 2014.
[19] Estimate provided by the Congressional Budget Office.
[20] Estimate does not include a decrease in outlays of $32 million for the fiscal years 2005 through 2015.
[21] Effective for articles sold by the manufacturer, producer, or importer after September 30, 2005.
[22] Effective with respect to transportation beginning after September 30, 2005, but shall not apply to any amount paid before that date for such transportation.
[23] Loss of less than $500,000.
[24] Estimate does not include a decrease in outlays of $9 million for the fiscal years 2005 through 2015.
[25] Effective on and after the date a State becomes the owner of all outstanding shares of a qualified corporation, provided that the State becomes owner of all of the voting stock of the corporation on or before December 31, 2003, and becomes the owner of all of the outstanding stock of the corporation on or before December 31, 2006.
[26] Effective for fuels or liquids removed, entered into the United States, or sold after September 30, 2005.
[27] Effective as if included in the section of the bill to which the technical correction applies.
[28] The "Hurricane Katrina disaster area" is defined as 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. The term "core disaster area" is defined as a 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.
[29] Increase in loan limits effective for loans made after the date of enactment and before January 1, 2007; repayment relief for loans outstanding on or after August 25, 2005.
[30] Contributions made during the period beginning August 28, 2005, and ending on December 31, 2005.
[31] Estimate includes an increase in outlays of $5 million in fiscal year 2006, and $2 million in fiscal year 2007.
[32] Estimate includes an increase in outlays of $123 million in fiscal year 2006.
[33] The "Gulf Opportunity Zone ('GO Zone')" is defined as that portion of the Hurricane Katrina disaster area determined by the President to warrant individual or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina. The "Hurricane Katrina disaster area" is defined as an area with respect to which a major disaster has been declared by the President before September 14, 2005, under section 401 of such Act by reason of Hurricane Katrina.
[34] Estimate includes one additional advance refunding of qualified 501(c)(3) bonds.
[35] The provisions relating to additional first-year depreciation, increased expensing under section 179, and the five-year carryback of NOLs attributable to casualty losses, depreciation, or amortization otherwise provided under new Code section 1400N do not apply with respect to certain property. Specifically, the provisions do not apply with respect to any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. The provisions also do not apply with respect to any gambling or animal racing property.
[36] The term "Rita GO Zone" means that portion of the Hurricane Rita disaster area determined by the President to warrant individual or individual and public assistance from the Federal Government under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Rita. 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.
[37] The term "Wilma GO Zone" means that portion of the Hurricane Wilma disaster area determined by the President to warrant individual or individual and public assistance from the Federal government under such Act by reason of Hurricane Wilma. The term "Hurricane Wilma disaster area" is defined as an area with respect to which a major disaster has been declared by the President before November 14, 2005, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act, by reason of Hurricane Rita.
[38] Effective for lodging provided during the six-month period beginning on the first day of the first month after date of enactment.
[39] Increase in loan limits effective for loans made after the date of enactment and before January 1, 2007; repayment relief for loans outstanding on or after September 23, 2005, and October 23, 2005.
[40] Contributions paid during the period beginning August 28, 2005, and ending on December 31, 2005.
[41] Effective as if included in the provision of the American Jobs Creation Act of 2004 to which it relates.
[42] The technical corrections generally take effect as if included in the original legislation to which each amendment relates.
[43] Effective for taxable years of foreign corporations beginning after December 31, 2006, and before January 1, 2009, and to taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.
[44] Effective for taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and to taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.
[45] Modification of definition of a qualified veteran is effective for bonds issued on or after the date of enactment. New State volume limitation is effective for allocations of State volume limits after April 5, 2006.
[46] Effective for calendar years beginning after December 31, 2005, with respect to loans made before, on, or after such date.
[47] The "Economic Growth and Tax Relief Reconciliation Act of 2001" provides that the child tax credit and adoption tax credit are allowed for purposes of the alternative minimum tax for 2002 through 2010. For purposes of the alternative minimum tax, the proposal does not treat the alternative motor vehicle credit and the alternative fuel vehicle refueling property credit as nonrefundable personal credits.
[48] Some of the provisions sunset December 31, 2007.
[49] Effective for taxable years ending after the date of enactment, with respect to transactions before, on, or after such date, except that no tax applies to income or proceeds that are properly allocable to the period ending 90 days after the date of enactment; effective for disclosures due after the date of enactment.
[50] Estimate does not include any changes in direct spending associated with the effects of the provisions on the PBGC, including the effect on premiums paid to the PBGC. Estimates of any such changes will be provided by the Congressional Budget Office.
[51] The extension of the present-law interest rate is effective for plan years beginning after December 31, 2005, and before January 1, 2008. The modifications to the single-employer plan funding rules are generally effective for plan years beginning after December 31, 2007.

*[Footnotes for the Appendix are continued on the following page]*

**Footnotes for the Appendix continued:**

[53] The additional funding rules for plans in endangered or critical status do not apply after December 31, 2014.
[54] The permanent extension of the termination premium enacted in the Deficit Reduction Act of 2005 is effective on the date of enactment.
[55] Estimate includes interaction effects with the provision relating to funding rules for single-employer defined benefit pension plans (Part Thirteen, item I.A.).
[56] Effective for benefits that become payable as a result of a plant shutdown or other covered event that occurs after July 26, 2005.
[57] Effective with respect to Federal bankruptcy or similar proceedings which are initiated on or after the date that is 30 days after enactment.
[58] Estimated increase in outlays provided by the Congressional Budget Office.
[59] Effective for plan terminations with respect to which notices of intent to terminate are provided, or for which proceedings for termination are instituted by the PBGC, after December 31, 2005.
[60] Effective as if included in section 306 of the Sarbanes-Oxley Act of 2002.
[61] Generally effective with respect to advice referred to in section 4975(c)(3)(B) of the Internal Revenue Code of 1986 provided after December 31, 2006.
[62] Effective for any transaction which the fiduciary or disqualified person discovers, or reasonably should have discovered, after the date of the enactment constitutes a prohibited transaction.
[63] Generally effective for contributions for taxable years beginning after December 31, 2005, or December 31, 2007.
[64] Generally effective as if included in the amendments made by section 1526 of the Taxpayer Relief Act of 1997, except that the provision regarding trustee-to-trustee transfers is effective as if included in the amendments made by section 647 of the Economic Growth and Tax Relief Reconciliation Act of 2001.
[65] Generally effective for contracts issued after December 31, 1996, but only with respect to taxable years beginning after December 31, 2009. The provisions relating to tax-free exchanges apply with respect to exchanges occurring after December 31, 2009. The provision relating to information reporting applies to charges made after December 31, 2009. The provision relating to policy acquisition expenses applies to specified policy acquisition expenses determined for taxable years beginning after December 31, 2009. The technical amendment relating to long-term care insurance coverage under section 7702B(e) is effective as if included with the underlying provisions of the Health Insurance Portability and Accountability Act of 1996.
[66] The estimated revenue effects relate to participation by Tax Court judges in the Thrift Savings Plan. The remaining items included in the provision are estimated by the Congressional Budget Office to have a negligible effect on outlays.
[67] Estimate includes interaction effects with EGTRRA IRA provisions (Part Thirteen, item VIII.B.2.).
[68] The preemption of State law is effective on the date of enactment.
[69] Negligible revenue effect.
[70] Estimate provided by the Congressional Budget Office and includes increase in outlays and revenues.
[71] Effective with respect to payments received or accrued after December 31, 2005, and before January 1, 2008. The reporting requirement is effective for returns the due date of which is after the date of enactment. The Treasury study must be completed by January 1, 2009.
[72] Generally effective on January 1, 2007, except the heavy vehicle use tax exemption is effective for taxable periods beginning on or after July 1, 2007.
[73] The reporting provision applies for purposes of acquisitions occurring on or after the date of enactment and before two years following the date of enactment. The Treasury study must be completed no later than 30 months after the date of enactment.
[74] The provision relating to taxidermy is effective for contributions made after July 25, 2006. The provision relating to exempt use property is effective for contributions made after September 1, 2006, returns filed after September 1, 2006, and with respect to penalties for identifications made after the date of enactment.
[75] With respect to qualified real property interests, effective for contributions or appraisals made after July 25, 2006.
[76] Estimate includes interaction with the supporting organizations proposal (Part Thirteen, item XII.B.16.).
[77] Estimate includes interaction with the donor advised funds proposal (Part Thirteen, item XII.B.15.).
[78] Estimate provided by the Congressional Budget Office.
[79] Effective with respect to goods entered, or withdrawn from warehouse for consumption, on or after the 15th day after the date of enactment.
[80] Estimate is net of revenues and outlays. Provision contains spending authority of $5 million in each of 2008 and 2009.
[81] Effective on the date of enactment and applies to vessel equipment, repair parts, and materials installed on or after April 25, 2001.
[82] Effective on the date of enactment, and the apparel proclamation authority extends until December 31, 2007.
[83] In the case of fiscal year 2006-2007 taxpayers, any increase in the credit attributable to the modifications is prorated. Also, the time for making certain elections for taxable years ending in 2006 and before the date of enactment is extended.
[84] Arbitrage restrictions and spending requirements effective for bonds issued after the date of enactment with respect to allocations of authority arising after 2005.
[85] Estimate provided by the Congressional Budget Office and should be considered preliminary and subject to change.
[86] Estimate provided by the Congressional Budget Office.
[87] The provision relating to charitable contributions for scientific property used for research is permanent. The provision relating to the enhanced deduction for charitable contributions of computer technology and equipment sunsets for taxable years beginning after December 31, 2007.
[88] Effective as if included in the Gulf Opportunity Zone Act of 2005.
[89] Effective for periods after December 31, 2007 (and before January 1, 2009 in the case of the 30-percent credit and fiber optic distributed sunlight), for property placed in service in taxable years ending after December 31, 2007.
[90] Effective for periods after December 31, 2007, and before January 1, 2009, for property placed in service in taxable years ending after December 31, 2007.
[91] Effective for property placed in service after the date of enactment, in taxable years ending after such date.
[92] The Congressional Budget Office estimates the provision has no outlay effects. The estimate provided by the Congressional Budget Office is preliminary and subject to change.
[93] Effective as if included in the amendments made by section 1321 of the Energy Policy Act of 2005.
[94] Rollover may not exceed the balance in the HRA or health FSA on September 21, 2006.
[95] Effective on the date of enactment with respect to coverage for taxable years beginning after December 31, 2006.
[96] Under the provision, HSA contributions would be permitted up to the statutory limits in present-law sections 223(b)(2)(A)(ii) and (B)(ii) of the Internal Revenue Code. These limits are indexed for inflation. In 2007 the limits will be $2,850 for single coverage and $5,650 for family coverage.

*[Footnotes for the Appendix are continued on the following page]*

**Footnotes for the Appendix continued:**

[97] A limit would apply to the sum of: (1) the amount allowed as a deductible contribution to the HSA; and (2) the amount rolled over from the IRA to the HSA. The sum of these two amounts would not be permitted to exceed the otherwise maximum annual deductible contribution.
[98] Estimate assumes compliance provisions are permanent.
[99] Estimate includes revenue effects only.
[100] The amendments made by this section shall apply to submissions made and issues raised after the date on which the Secretary first prescribes a list under Section 6702(c) of the Internal Revenue Code of 1986, as amended.
[101] Estimate includes outlay effects provided by the Congressional Budget Office.
[102] Gain or loss of less than $500,000.
[103] Effective as if included in the Tax Increase Prevention and Reconciliation Act of 2005.
[104] Generally effective for kerosene sold after September 30, 2005. The special rule applicable to kerosene purchased prior to October 1, 2005, and used in aviation on a farm for farming purposes is effective on the date of enactment.
[105] Effective as if included in section 103(b) of the Tax Increase Prevention and Reconciliation Act of 2005.
[106] Effective as if included in section 903 of the American Jobs Creation Act of 2004.

| [107] The net budget effects provided by the Congressional Budget Office include the following increases in outlays | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2006-11 | 2006-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 40 | 40 | 450 | 480 | 570 | 590 | 640 | 660 | 630 | 420 | 430 | 2,130 | 4,910 |

[108] Estimate includes the effect of the proposal on customs duties which the Congressional Budget Office estimates to be negligible.