

**TECHNICAL EXPLANATION OF H.R. 6408,  
THE “TAX RELIEF AND HEALTH CARE ACT OF 2006,”  
AS INTRODUCED IN THE HOUSE ON DECEMBER 7, 2006**

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of the  
JOINT COMMITTEE ON TAXATION



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## INTRODUCTION

This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation,<sup>2</sup> provides a technical explanation of the provisions in H.R. 6408, the “Tax Relief and Health Care Act of 2006,” as introduced in the House on December 7, 2006

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<sup>1</sup> This document may be cited as follows: 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.

<sup>2</sup> Descriptions of the following provisions, however, were supplied by the Majority Staff of the Ways and Means Committee: (1) Medicare and Other Health Provisions; (2) Gulf of Mexico Energy Security; (3) Study on Establishing Uniform National Data on Elder Abuse; (4) Extension of Temporary Duty of Ethyl Alcohol; (5) Continuing Eligibility for Certain Students Under District of Columbia School Choice Program.

**I. DIVISION A – EXTENSION AND EXPANSION OF CERTAIN  
TAX PROVISIONS AND OTHER PROVISIONS<sup>3</sup>**

**TITLE I – EXTENSION AND MODIFICATION OF CERTAIN PROVISIONS**

**1. Above-the-line deduction for higher education expenses (sec. 101 of the bill 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 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

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<sup>3</sup> Some provisions that are identical or similar to provisions in this bill were included in other bills reported by the House Ways and Means Committee or the Senate Finance Committee, or passed by the House of Representatives or the Senate, during the 109<sup>th</sup> Congress. These bills include H.R. 4297, H.R. 5638, H.R. 4323, H.R. 4388, H.R. 5970, and S. 2020.

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 bill 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”).<sup>4</sup> The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years. The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available for a taxable year to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE. A qualified equity investment means stock (other than nonqualified preferred stock 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

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<sup>4</sup> 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).

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.<sup>5</sup> Under such Act, a targeted population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under section 1391, and is contiguous to one or more low-income communities.

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

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

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<sup>5</sup> 12 U.S.C. 4702(17) defines “low-income” for purposes of 12 U.S.C. 4702(20).

### **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 bill 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 bill 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.<sup>6</sup> Thus, the research credit was generally available with respect to incremental increases in qualified research.

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.

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<sup>6</sup> Sec. 41.

## **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.<sup>7</sup>

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, 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.<sup>8</sup> 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

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<sup>7</sup> 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)).

<sup>8</sup> Sec. 41(c)(4).

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).<sup>9</sup> 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 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.

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<sup>9</sup> 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).

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.<sup>10</sup> 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 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 research 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

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<sup>10</sup> 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).

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 bill 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. Election to treat combat pay as earned income for purposes of the earned income credit (sec. 106 of the bill 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 bill 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.<sup>11</sup> Generally, this information return is required to be filed no later the 15<sup>th</sup> 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

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<sup>11</sup> Sec. 149(e).

bonds (“QZABS”), clean renewable energy bonds (“CREBS”), and “Gulf tax credit bonds.”<sup>12</sup> 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, provided that: (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy” (“qualified zone academy property”) and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

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

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

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<sup>12</sup> Secs. 1397E, 54, and 1400N(l), respectively.

not apply to any arbitrage bond.<sup>13</sup> 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.<sup>14</sup> 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. 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.

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<sup>13</sup> Sec. 103(b)(2).

<sup>14</sup> Sec. 148.

### 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 bill 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).<sup>15</sup> In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

Certain expenses of eligible educators are allowed an above-the-line deduction. Specifically, for taxable years beginning 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.

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<sup>15</sup> 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).

## 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.

## **9. Extension and expansion to petroleum products of expensing for environmental remediation costs (sec. 109 of the bill 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.<sup>16</sup> 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.<sup>17</sup> The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. 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.*<sup>18</sup> 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

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<sup>16</sup> Sec. 162.

<sup>17</sup> Sec. 198.

<sup>18</sup> 418 U.S. 1 (1974).

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”)<sup>19</sup> 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 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).<sup>20</sup>

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.<sup>21</sup>

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<sup>19</sup> Pub. L. No. 96-510 (1980).

<sup>20</sup> Section 101(14) of CERCLA specifically excludes “petroleum, including crude oil or any fraction thereof which is not otherwise specifically listed or designated as a hazardous substance under subparagraphs (A) through (F) of this paragraph,” from the definition of “hazardous substance.”

<sup>21</sup> The present law exceptions for sites on the national priorities list under CERCLA, and for substances with respect to which a removal or remediation is not permitted under section 104 of

### Effective Date

The provision applies to expenditures paid or incurred after December 31, 2005, and before January 1, 2008.

### **10. Tax incentives for investment in the District of Columbia (sec. 110 of the bill 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.”<sup>22</sup>

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CERCLA by reason of subsection (a)(3) thereof, would continue to apply to all hazardous substances (including petroleum products).

<sup>22</sup> However, the wage credit is not available for wages paid in connection with certain business activities described in section 144(c)(6)(B) or certain farming activities. In addition, wages are not eligible for the wage credit if paid to (1) a person who owns more than five percent of the stock (or capital

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.<sup>23</sup> Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer's work opportunity tax credit under section 51 or the welfare-to-work credit under section 51A.<sup>24</sup> In addition, the \$15,000 cap is reduced by any wages taken into account in computing the work opportunity tax credit or the welfare-to-work credit.<sup>25</sup> The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.<sup>26</sup>

### **Section 179 expensing**

In general, a D.C. Zone business is allowed an additional \$35,000 of section 179 expensing for qualifying property placed in service by a D.C. Zone business.<sup>27</sup> The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified zone property placed in service during the year by the taxpayer exceeds \$200,000 (\$400,000 for taxable years beginning after 2002 and before 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.<sup>28</sup> Special rules are provided in the case of property that is substantially renovated by the taxpayer.

### **Tax-exempt financing**

A qualified D.C. Zone business is permitted to borrow proceeds from tax-exempt qualified enterprise zone facility bonds (as defined in section 1394) issued by the District of Columbia.<sup>29</sup> Such bonds are subject to the District of Columbia's annual private activity bond volume limitation. Generally, qualified enterprise zone facility bonds for the District of Columbia are bonds 95 percent or more of the net proceeds of which are used to finance certain facilities within the D.C. Zone. The aggregate face amount of all outstanding qualified

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or profits interests) of the employer, (2) certain relatives of the employer, or (3) if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business.

<sup>23</sup> Sec. 280C(a).

<sup>24</sup> Secs. 1400H(a), 1396(c)(3)(A) and 51A(d)(2).

<sup>25</sup> Secs. 1400H(a), 1396(c)(3)(B) and 51A(d)(2).

<sup>26</sup> Sec. 38(c)(2).

<sup>27</sup> Sec. 1397A.

<sup>28</sup> Sec. 1397D.

<sup>29</sup> Sec. 1400A.

enterprise zone facility bonds per qualified D.C. Zone business may not exceed \$15 million and may be issued only while the D.C. Zone designation is in effect.

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

A zero-percent capital gains rate applies to capital gains from the sale of certain qualified D.C. Zone assets held for more than five years.<sup>30</sup> In general, a qualified “D.C. Zone asset” means stock or partnership interests held in, or tangible property held by, a D.C. Zone business. For purposes of the zero-percent capital gains rate, the D.C. Enterprise Zone is defined to include all census tracts within the District of Columbia where the poverty rate is not less than 10 percent.

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

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

First-time homebuyers of a principal residence in the District of Columbia are eligible for a nonrefundable tax credit of up to \$5,000 of the amount of the purchase price. The \$5,000 maximum credit applies both to individuals and married couples. Married individuals filing 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.<sup>32</sup>

### **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.

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<sup>30</sup> Sec. 1400B.

<sup>31</sup> However, sole proprietorships and other taxpayers selling assets directly cannot claim the zero-percent rate on capital gain from the sale of any intangible property (i.e., the integrally related test does not apply).

<sup>32</sup> Sec. 1400C(i).

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 bill 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 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 C.F.R. 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 bill 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:

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

“Qualified Indian reservation property” eligible for accelerated depreciation includes property which is (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation, (2) not used or located outside the reservation on a regular basis, (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer (within the meaning of section 465(b)(3)(C)), and (4) described in the recovery-period table above. In addition, property is not “qualified Indian reservation property” if it is placed in service for purposes of conducting gaming activities. Certain “qualified infrastructure property” may be eligible for the accelerated depreciation even if located outside an Indian reservation, provided that the purpose of such property is to connect with qualified infrastructure property

located within the reservation (e.g., roads, power lines, water systems, railroad spurs, and communications facilities).

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

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax. The accelerated depreciation for Indian 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 bill 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 occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building. However, if a lessor makes an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

### **Qualified restaurant property**

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

### **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 bill and sec. 7652 of the Code)**

##### **Present Law**

A \$13.50 per proof gallon<sup>33</sup> excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States.<sup>34</sup> The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions (e.g., Puerto Rico and the Virgin Islands).<sup>35</sup>

The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin.<sup>36</sup> The amount of the cover over is limited under Code section 7652(f) to \$10.50 per proof gallon (\$13.25 per proof gallon during the period July 1, 1999 through December 31, 2005).

Tax amounts attributable to shipments to the United States of rum produced in Puerto Rico are covered over to Puerto Rico. Tax amounts attributable to shipments to the United States of rum produced in the Virgin Islands are covered over to the Virgin Islands. Tax amounts attributable to shipments to the United States of rum produced in neither Puerto Rico nor the Virgin Islands are divided and covered over to the two possessions under a formula.<sup>37</sup> Amounts covered over to Puerto Rico and the Virgin Islands are deposited into the treasuries of the two possessions for use as those possessions determine.<sup>38</sup> 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.

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<sup>33</sup> A proof gallon is a liquid gallon consisting of 50 percent alcohol. *See* sec. 5002(a)(10) and (11).

<sup>34</sup> Sec. 5001(a)(1).

<sup>35</sup> Secs. 5062(b), 7653(b) and (c).

<sup>36</sup> Secs. 7652(a)(3), (b)(3), and (e)(1). One percent of the amount of excise tax collected from imports into the United States of articles produced in the Virgin Islands is retained by the United States under section 7652(b)(3).

<sup>37</sup> Sec. 7652(e)(2).

<sup>38</sup> Secs. 7652(a)(3), (b)(3), and (e)(1).

### **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 bill 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, 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 bill 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.<sup>39</sup>

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 "qualified research contribution" or a "qualified computer contribution."<sup>40</sup> 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

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<sup>39</sup> Sec. 170(e)(1).

<sup>40</sup> Secs. 170(e)(4) and 170(e)(6).

substantially completed.<sup>41</sup> The original use of the property must be by the donor or the donee,<sup>42</sup> and in the case of the donee, must be used substantially for educational purposes related to the function or purpose of the donee. The property must fit productively into the donee's education plan. The donee may not transfer the property in exchange for money, other property, or services, except for shipping, installation, and transfer costs. To determine whether property is constructed by the taxpayer, the rules applicable to qualified research contributions apply. Contributions may be made to private foundations under certain conditions.<sup>43</sup>

### **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.

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 bill 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,

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<sup>41</sup> 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).

<sup>42</sup> This requirement does not apply if the property was reacquired by the manufacturer and contributed. Sec. 170(e)(6)(D)(ii).

<sup>43</sup> Sec. 170(e)(6)(C).

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 provide 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 bill 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 with respect to American Samoa (sec. 119 of the bill)**

#### **Present Law**

##### **In general**

Certain domestic corporations with business operations in the U.S. possessions are eligible for the possession tax credit.<sup>44</sup> This credit offsets the U.S. tax imposed on certain income related to operations in the U.S. possessions.<sup>45</sup> 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.<sup>46</sup> 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

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<sup>44</sup> Secs. 27(b), 936.

<sup>45</sup> 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.

<sup>46</sup> 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.

account in computing the credit under section 936.<sup>47</sup> 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 limit.

### **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.<sup>48</sup> A corporation that adds a substantial new line of 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.

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<sup>47</sup> Sec. 936(c).

<sup>48</sup> 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 possession 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.

### **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 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 bill 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<sup>49</sup> property. In order to qualify, property generally must be placed in service on or before December 31, 2007 (December 31, 2008 in the case of nonresidential real property and residential rental property).

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

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<sup>49</sup> 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. 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.

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.

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.<sup>50</sup> 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)<sup>51</sup> 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.)<sup>52</sup>

### **Effective Date**

The provision applies as if included in section 101 of the Gulf Opportunity Zone Act of 2005<sup>53</sup> (“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.

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<sup>50</sup> 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.

<sup>51</sup> 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.

<sup>52</sup> 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](http://www.dhs.gov/xlibrary/assets/GulfCoast_HousingDamageEstimates_021206.pdf) (last accessed December 5, 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.

<sup>53</sup> Pub. L. No. 109-135 (2005).

## **21. Authority for undercover operations (sec. 121 of the bill 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.

## **22. Disclosures of certain tax return information (sec. 122 of the bill 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.<sup>54</sup> The Federal disclosure restrictions, safeguard requirements, and criminal

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<sup>54</sup> Sec. 6103(d)(5).

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.<sup>55</sup> 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 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.<sup>56</sup> In general, returns and taxpayer return information must be obtained pursuant to an ex parte court order. Return

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<sup>55</sup> Treas. Reg. sec. 301.6103(c)-1(d)(2).

<sup>56</sup> 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.

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.

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

If the Secretary 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 Treasury for intelligence analysis of terrorist activity

Upon written request satisfying certain requirements discussed below, the IRS is to disclose return information (other than taxpayer return information) to officers and employees of the Department of Justice, Department of Treasury, and other Federal intelligence agencies, who are personally and directly engaged in the collection or analysis of intelligence and counterintelligence or investigation concerning terrorist incidents, threats, or activities. Use of the information is limited to use by such officers and employees in such investigation, collection, or analysis.

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

terrorist incidents, threats, or activities. The Director of the United States Secret Service also is an authorized requester under the Act.

### **Explanation of Provision**

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

#### **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 bill, an election under section 41(c)(4), 280C(c)(3)(C), or any other expired provision of the Code which is extended by the bill 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 bill 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 party 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 SO<sub>2</sub> 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 1.—Summary of Section 45 Credit for Electricity Produced from Certain Renewable Resources, for Refined Coal, and for Indian Coal**

<b>Eligible electricity production or coal production activity</b>	<b>Credit amount for 2006 (cents per kilowatt- hour; dollars per ton)</b>	<b>Credit period for facilities placed in service on or before August 8, 2005 (years from placed-in-service date)</b>	<b>Credit period for facilities placed in service after August 8, 2005 (years from placed-in-service date)</b>
Wind	1.9	10	10
Closed-loop biomass	1.9	10 <sup>1</sup>	10 <sup>1</sup>
Open-loop biomass (including agricultural livestock waste nutrient facilities)	0.9	5 <sup>2</sup>	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 <sup>3</sup>	7 <sup>3</sup>

<sup>1</sup> In the case of certain co-firing closed-loop facilities, the credit period begins no earlier than October 22, 2004.

<sup>2</sup> For certain facilities placed in service before October 22, 2004, the 5-year credit period commences on January 1, 2005.

<sup>3</sup> 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 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<sup>57</sup> 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.<sup>58</sup> 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.

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<sup>57</sup> Sec. 1381, et seq.

<sup>58</sup> Sec. 1382.

## **2. Extension and expansion of clean renewable energy bonds (sec. 202 of the bill 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.<sup>59</sup> 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.<sup>60</sup> 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.<sup>61</sup> Generally, this information return is required to be filed no later the 15<sup>th</sup> day of the second month after the close of the calendar quarter in which the bonds were issued.

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<sup>59</sup> Secs. 103(a) and (b)(2).

<sup>60</sup> Sec. 148.

<sup>61</sup> Sec. 149(e).

## **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 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 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 bill 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 bill 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 bill 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 bill 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 bill 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 than 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 bill 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 bill 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 attributable 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 bill and sec. 9508 of the Code)**

### **Present Law**

#### **Internal Revenue Code provisions**

Section 1362 of the Energy Policy Act of 2005<sup>62</sup> 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.<sup>63</sup>

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.<sup>64</sup>

#### **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 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.<sup>65</sup>

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

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<sup>62</sup> Pub. L. No. 109-58.

<sup>63</sup> Sec. 9508(c).

<sup>64</sup> 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).

<sup>65</sup> 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).

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.<sup>66</sup>

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

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<sup>66</sup> 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;
  - (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.

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**

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.

## **11. Modification of credit for fuel from a non-conventional source (sec. 211 of the bill 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)<sup>67</sup> per barrel or Btu oil barrel equivalent (“non-conventional source fuel credit”).<sup>68</sup> 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).

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<sup>67</sup> 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.

<sup>68</sup> Sec. 29 (for tax years ending before 2006); sec. 45K (for tax years ending after 2005).

### **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.

### **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 (sec. 301 - 307 of the bill 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.<sup>69</sup> Eligible individuals do not include individuals who may be claimed as a dependent on another person’s tax return.

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 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.

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<sup>69</sup> 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.

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.<sup>70</sup> 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 arrangement (“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.<sup>71</sup>

#### 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

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<sup>70</sup> 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).

<sup>71</sup> 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 HSA pays or reimburses only medical expenses incurred after retirement.

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.

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.<sup>72</sup> 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.

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<sup>72</sup> 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.

### 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.

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.<sup>73</sup> 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.<sup>74</sup> 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.<sup>75</sup> 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.<sup>76</sup> 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

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<sup>73</sup> Sec. 125(d)(2).

<sup>74</sup> Notice 2005-42, 2005-23 I.R.B. 1204.

<sup>75</sup> Notice 2005-86, 2005-49 I.R.B. 1075.

<sup>76</sup> Guidance with respect to HRAs, including the interaction of FSAs and HRAs in the case an individual is covered under both, is provided in Notice 2002-45, 2002-2 C.B. 93.

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 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 30, 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 bill.<sup>77</sup>

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 bill) 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.

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<sup>77</sup> 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<sup>78</sup> (for 2007) and (B) if 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).

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<sup>78</sup> This amount is indexed for inflation.

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 health 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 bill 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<sup>79</sup> 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<sup>80</sup> 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.

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<sup>79</sup> “Qualifying production property” generally includes any tangible personal property, computer software, or sound recordings.

<sup>80</sup> “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.<sup>81</sup>

### **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.<sup>82</sup> Wages paid to bona fide residents of Puerto Rico generally are not included in the wage limitation amount.<sup>83</sup>

### **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.

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<sup>81</sup> Sec. 7701(a)(9) (“the term ‘United States’ when used in a geographical sense includes only the States and the District of Columbia”).

<sup>82</sup> 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.

<sup>83</sup> Sec. 3401(a)(8)(C).

## **2. Alternative minimum tax credit relief for individuals; returns required for certain options (secs. 402 and 403 of the bill 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 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.<sup>84</sup> 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.<sup>85</sup> 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.<sup>86</sup>

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<sup>84</sup> Sec. 422.

<sup>85</sup> Sec. 421.

<sup>86</sup> 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.

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.<sup>87</sup> 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.<sup>88</sup>

### **Furnishing of information**

Under present law,<sup>89</sup> 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.<sup>90</sup>

### **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.

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<sup>87</sup> If the stock is sold in the same taxable year the option is exercised, no adjustment in computing AMTI is required.

<sup>88</sup> 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.

<sup>89</sup> Sec. 6039.

<sup>90</sup> Sec. 423(c).

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.

### **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 bill 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.<sup>91</sup>

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.

#### **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.

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<sup>91</sup> 1987-2 C.B. 674 (as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785).

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 bill 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.<sup>92</sup> 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.<sup>93</sup> 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

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<sup>92</sup> Sec. 162(a).

<sup>93</sup> The credit is part of the general business credit (sec. 38).

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 bill 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.”<sup>94</sup> 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 relationship 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.<sup>95</sup>

### **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.

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<sup>94</sup> Sec. 7623.

<sup>95</sup> Sec. 6103(n).

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.<sup>96</sup> 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 (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 bill 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<sup>97</sup> to

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<sup>96</sup> Treasury Inspector General for Tax Administration, *The Informants' Rewards Program Needs More Centralized Management Oversight*, 2006-30-092 (June 2006).

<sup>97</sup> 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.

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.

## **7. Addition of meningococcal and human papillomavirus vaccines to the list of taxable vaccines (sec. 408 of the bill and sec. 4132 of the Code)**

### **Present Law**

A manufacturer's excise tax is imposed at the rate of 75 cents per dose<sup>98</sup> 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.

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<sup>98</sup> Sec. 4131.

### **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 bill 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 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.

### **9. Make permanent the active business rules relating to taxation of distributions of stock and securities of a controlled corporation (sec. 410 of the bill 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").<sup>99</sup> For this purpose, prior to the enactment of the Tax Increase Prevention and Reconciliation Act of 2005, 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.<sup>100</sup> Thus, different tests applied, depending

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<sup>99</sup> 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.

<sup>100</sup> 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.

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.

The Tax Increase Prevention and Reconciliation Act of 2005 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 the Tax Increase Prevention and Reconciliation Act of 2005 applies to distributions after the date of enactment 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 other restructuring after such date on or before December 31, 2010.<sup>101</sup>

### **Explanation of Provision**

The provision deletes the sunset date of December 31, 2010, for all purposes of the provision enacted in the Tax Increase Prevention and Reconciliation Act of 2005. Thus, that provision is made permanent.

### **Effective Date**

The provision is effective as if included in section 202 of the Tax Increase Prevention and Reconciliation Act of 2005.

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<sup>101</sup> 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, 2010, and that would satisfy the requirements of new section 355(b)(2)(A).

**10. Make permanent the modifications to qualified veterans’ mortgage bonds (sec. 411 of the bill 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 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, the Tax Increase Prevention and Reconciliation Act of 2005 (“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.

<b>Calendar Year:</b>	<b>Applicable Percentage is:</b>
2006	20 percent

<b>Calendar Year:</b>	<b>Applicable Percentage is:</b>
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.

### **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 bill 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.<sup>102</sup> 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).<sup>103</sup> Under a provision included in the Tax Increase Prevention and Reconciliation

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<sup>102</sup> Sec. 1221(a)(1).

<sup>103</sup> Sec. 1221(a)(3).

Act of 2005 (“TIPRA”),<sup>104</sup> 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).<sup>105</sup> 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.<sup>106</sup> 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.<sup>107</sup>

### **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 the Tax Increase Prevention and Reconciliation Act of 2005.

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<sup>104</sup> Pub. L. No. 109-222, sec. 204(a) (2006).

<sup>105</sup> Sec. 1221(b)(3).

<sup>106</sup> Sec. 170(e)(1)(A).

<sup>107</sup> 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 bill 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”)<sup>108</sup> generally allows corporations that are qualifying vessel operators<sup>109</sup> 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

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<sup>108</sup> 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).

<sup>109</sup> 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.

the maximum corporate income tax rate on their notional shipping income, which is based on the net tonnage of the corporation's qualifying vessels.<sup>110</sup> 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 the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"),<sup>111</sup> 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<sup>112</sup> 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 the Tax Increase Prevention and Reconciliation Act of 2005.

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<sup>110</sup> 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.

<sup>111</sup> Pub. L. No. 109-222, sec. 205 (May 17, 2006).

<sup>112</sup> 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.

### **13. Make permanent the modification of special arbitrage rule for certain funds (sec. 414 of the bill)**

#### **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 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.<sup>113</sup>

The Tax Increase Prevention and Reconciliation Act of 2005 (“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.

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<sup>113</sup> H.R. 2661.

### **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 bill 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")<sup>114</sup> generally allows corporations that are qualifying vessel operators<sup>115</sup> to elect a

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<sup>114</sup> 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).

“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),<sup>116</sup> 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.<sup>117</sup> “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. 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<sup>118</sup> 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.<sup>119</sup>

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<sup>115</sup> 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.

<sup>116</sup> Sec. 1357.

<sup>117</sup> 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.

<sup>118</sup> Prior to the enactment on May 17, 2006 of Pub. L. No. 109-222, the Tax Increase Prevention and Reconciliation Act of 2005 (“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 1283 of this Act permanently extends the 6,000 deadweight tons threshold.

<sup>119</sup> Sec. 1355(g).

### **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 Erie, 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-Îles, 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 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 bill 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 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, the Tax Increase Prevention and Reconciliation Act of 2005 (“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 a member of the intelligence community (sec. 417 of the bill 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 includes 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 bill 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 created 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. Premiums for mortgage insurance (sec. 419 of the bill 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 \$110,000 (\$55,000 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 21, 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 bill 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.<sup>120</sup> However, the 0.1 cent per gallon representing the Leaking Underground Storage Tank Trust Fund financing rate generally is not refundable, except for exports.<sup>121</sup>

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.<sup>122</sup> Nontaxable uses of kerosene include:

- Use on a farm for farming purposes;<sup>123</sup>
- Use in foreign trade or trade between the United States and any of its possessions;<sup>124</sup>
- 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;<sup>125</sup>
- Exclusive use of a state or local government;<sup>126</sup>

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<sup>120</sup> Sec. 6427(l).

<sup>121</sup> Sec. 6430.

<sup>122</sup> Sec. 6427(l)(2).

<sup>123</sup> Sec. 4041(f).

<sup>124</sup> Sec. 4041(g)(1).

<sup>125</sup> Id.

- Export or shipment to a possession of the United States;<sup>127</sup>
- Exclusive use of a nonprofit educational organization;<sup>128</sup>
- 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;<sup>129</sup> 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) by a fixed-wing aircraft equipped for and exclusively dedicated on that flight to acute care emergency medical services.<sup>130</sup>
- 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.<sup>131</sup> 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.<sup>132</sup> 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

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<sup>126</sup> Sec. 4041(g)(2).

<sup>127</sup> Sec. 4041(g)(3).

<sup>128</sup> Sec. 4041(g)(4).

<sup>129</sup> Sec. 4041(h).

<sup>130</sup> Secs. 4041(l), 4261(f) and (g).

<sup>131</sup> “Commercial aviation” does not include aircraft used for skydiving, small aircraft on nonestablished lines or transportation for affiliated group members.

<sup>132</sup> Sec. 11161 of Pub. L. No. 109-59 (2005).

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).<sup>133</sup> 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.<sup>134</sup> 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.<sup>135</sup>

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.<sup>136</sup>

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.<sup>137</sup> 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.<sup>138</sup>

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<sup>133</sup> Sec. 6427(l)(1), (4) and (5).

<sup>134</sup> Sec. 6427(l)(5)(B).

<sup>135</sup> 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.

<sup>136</sup> Sec. 6427(l)(4)(B).

<sup>137</sup> Sec. 6427(l)(6).

<sup>138</sup> 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.

## **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.

## **20. Regional income tax agencies treated as States for purposes of confidentiality and disclosure requirements (sec. 421 of the bill 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.<sup>139</sup> 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.<sup>140</sup>

The term “State” includes the 50 States, the District of Columbia, and certain territories.<sup>141</sup> 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.<sup>142</sup>

### **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.

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

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<sup>139</sup> Sec. 6103(d)(1).

<sup>140</sup> Sec. 6103(n).

<sup>141</sup> Sec. 6103(b)(5)(A).

<sup>142</sup> Sec. 6103(b)(5)(B).

from disclosing data in a form which cannot be associated with or otherwise identify directly or indirectly a particular taxpayer.<sup>143</sup>

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 bill 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, 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.<sup>144</sup>

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<sup>143</sup> 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)).

<sup>144</sup> See 27 C.F.R. sec. 4.24(b).

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 bill 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 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 than 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 bill 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.<sup>145</sup>

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 current and previously undistributed ordinary income for the trust's year in which the distribution occurred; (2) capital gains to the extent of the trust's current capital gain and previously undistributed capital gain for the trust's year in which the distribution occurred; (3) other income (e.g., tax-exempt income) to the extent of the trust's current and previously undistributed other income for the trust's year in which the distribution occurred; and (4) corpus.<sup>146</sup>

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.<sup>147</sup>

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.

### **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.

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<sup>145</sup> Sec. 664(d).

<sup>146</sup> Sec. 664(b).

<sup>147</sup> Treas. Reg. sec. 1.664-1(d)(4).

### 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 bill and sec. 7872(h) of the Code)**

### Present Law

#### In general

For calendar years beginning before January 1, 2006, 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).<sup>148</sup>

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.<sup>149</sup>

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).<sup>150</sup>

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.<sup>151</sup>

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

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<sup>148</sup> Sec. 7872.

<sup>149</sup> Sec. 7872(g).

<sup>150</sup> Rev. Rul. 2005-75, 2005-49 I.R.B. 1073.

<sup>151</sup> Sec. 7872(g)(3).

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.<sup>152</sup>

### **Special rule for calendar years beginning after 2005 and before 2011**

The Tax Increase Prevention and Reconciliation Act of 2005 (“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.<sup>153</sup>

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.<sup>154</sup>

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.

### **Explanation of Provision**

The provision makes permanent the TIPRA modifications to section 7872 regarding below-market loans to qualified continuing care facilities.

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<sup>152</sup> Sec. 7872(g)(4).

<sup>153</sup> Sec. 7872(h).

<sup>154</sup> Sec. 7872(h)(2).

## Effective Date

The provision is effective as if included in section 209 of the TIPRA.

### **25. Tax technical corrections (sec. 426 of the bill)**

#### **In general**

The bill includes technical corrections to recently enacted tax legislation. Except as otherwise provided, the amendments made by the technical corrections contained in the bill 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 B – MEDICARE AND OTHER HEALTH PROVISIONS<sup>155</sup>**

The bill contains medicare and other health provisions.

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<sup>155</sup> The description of this provision was supplied by the Majority Staff of the Ways and Means Committee.

### **III. DIVISION C – OTHER PROVISIONS**

#### **TITLE I – GULF OF MEXICO ENERGY SECURITY<sup>156</sup>**

The provision provides for exploration, development, and production activities for mineral resources in the Gulf of Mexico.

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<sup>156</sup> The description of this provision was supplied by the Majority Staff of the Ways and Means Committee.

**TITLE II – SURFACE MINING CONTROL AND RECLAMATION  
ACT AMENDMENTS OF 2006<sup>157</sup>**

**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 bill 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<sup>158</sup> 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 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.<sup>159</sup> 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.

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<sup>157</sup> 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.

<sup>158</sup> Sec. 9701(c)(2).

<sup>159</sup> Sec. 9711(a).

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.<sup>160</sup> 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.

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 in the account (and earning thereon) shall be refunded to the entity as designated by the parent of the controlled group.

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<sup>160</sup> Sec. 9712.

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 bill 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 III – OTHER PROVISIONS

### 1. Clarification of prohibition of delivery sales of tobacco products (sec. 301 of the bill 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.<sup>161</sup> The tax is imposed on the manufacturer or importer and is determined at the time of removal.<sup>162</sup> 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.<sup>163</sup> 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.<sup>164</sup>

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.<sup>165</sup> 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.<sup>166</sup> 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.<sup>167</sup>

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<sup>161</sup> 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).

<sup>162</sup> Sec. 5703(b).

<sup>163</sup> 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).

<sup>164</sup> HTS, chapter 98, subchapter IV, sec. 9804.00.72.

<sup>165</sup> Sec. 5704(b).

<sup>166</sup> Sec. 5754(a)(1)(C).

<sup>167</sup> Sec. 5761(c).

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 customs law.<sup>168</sup> Customs law also provides for penalties, forfeiture, and destruction of noncompliant products.<sup>169</sup>

### **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 15<sup>th</sup> day after the date of enactment.

## **2. Extension of temporary duty on ethyl alcohol<sup>170</sup> (sec. 302 of the bill)**

### **Present Law**

Heading 9901.00.50 of the Harmonized Tariff Schedule of the United States imposes a cumulative general duty of 14.27 cents per liter (approximately 54 cents per gallon) to imports of ethyl alcohol, and any mixture containing ethyl alcohol, if used as a fuel or in producing a

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<sup>168</sup> 19 U.S.C. sec. 1681a.

<sup>169</sup> 19 U.S.C. sec. 1681b.

<sup>170</sup> The description of this provision was supplied by the Majority Staff of the Ways and Means Committee.

mixture to be used as a fuel, that are entered into the United States prior to October 1, 2007. The temporary duty under heading 9901.00.50 offsets the alcohol fuels credit of 51 cents per gallon that is available to taxpayers that blend ethanol with gasoline; both domestic and imported ethanol is eligible for the alcohol fuels credit.

Heading 9901.00.52 of the Harmonized Tariff Schedule of the United States imposes a general duty of 5.99 cents per liter to imports of ethyl tertiary-butyl ether, and any mixture containing ethyl tertiary-butyl ether, that are entered into the United States prior to October 1, 2007.<sup>171</sup>

### **Explanation of Provision**

The provision modifies the existing effective period for ethyl alcohol as classified under heading 9901.00.50 and 9901.00.52 of the Harmonized Tariff Schedule of the United States from before October 1, 2007 to before January 1, 2009.

### **Effective Date**

The provision is effective on the date of enactment.

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<sup>171</sup> Ethyl tertiary butyl ether (“ETBE”) is an ether that is manufactured using ethanol. For purposes of the alcohol fuel mixture credits provided by the Code (currently 51 cents per gallon of ethanol used in a qualified mixture) a blend of gasoline and ETBE is considered to be a mixture of gasoline and the ethanol used to produce the ETBE. Treas. Reg. sec. 1.40-1. Thus, producers of alcohol fuel mixtures may claim the alcohol fuel mixture credit for the ethanol used in the production of the ETBE if the requirements for claiming the credit are met.

### **3. Exclusion of 25 percent of capital gain for certain sales of mineral and oil leases for conservation purposes (sec. 303 of the bill)**

#### **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 mineral or geothermal interest.<sup>172</sup> The conservation sale must be made to an eligible entity that intends that the acquired property be used for qualified conservation purposes in perpetuity.<sup>173</sup>

##### **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 Blackfoot 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 from 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., Rs 13 and 14 W. All such land is as generally depicted on the map entitled "Rocky

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<sup>172</sup> 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.

<sup>173</sup> 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.

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 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.

#### **4. Continuing eligibility for certain students under District of Columbia school choice program<sup>174</sup> (sec. 304 of the bill)**

The provision allows for the continued receipt of scholarships by certain children in Washington, D.C. by ensuring that children in families with incomes under 300 percent of poverty remain eligible for such scholarships.

#### **5. Study on establishing uniform national database on elder abuse<sup>175</sup> (sec. 305 of the bill)**

### **Present Law**

The Social Services Block Grant authorized under Title XX of the Social Security Act, among other current programs, provides funding for services and other activities to help States and localities prevent elder abuse.

### **Explanation of Provision**

Requires the Secretary of HHS, in consultation with the Attorney General, to conduct a study on issues related to establishing a uniform national database on elder abuse. Authorizes a total of \$1 million for this study during fiscal years 2007 and 2008.

### **Effective Date**

Funds would be authorized for this study during fiscal years 2007 and 2008.

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<sup>174</sup> The description of this provision was supplied by the Majority Staff of the Ways and Means Committee.

<sup>175</sup> The description of this provision was supplied by the Majority Staff of the Ways and Means Committee.