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109TH CONGRESS
2d Session

HOUSE OF REPRESENTATIVES

REPORT
109–455

TAX INCREASE PREVENTION AND RECONCILIATION ACT OF 2005

CONFERENCE REPORT

TO ACCOMPANY

H.R. 4297

MAY 9, 2006.—Ordered to be printed

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Mr. THOMAS, from the Committee of Conference, submitted the following

CONFERENCE REPORT

[To accompany H.R. 4297]

The committee of conference on the disagreeing votes of the two Houses on the amendment of the Senate to the bill (H.R. 4297), to provide for reconciliation pursuant to section 201(b) of the concurrent resolution on the budget for fiscal year 2006, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the House recede from its disagreement to the amendment of the Senate and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the Senate amendment, insert the following:

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE.—This Act may be cited as the "Tax Increase Prevention and Reconciliation Act of 2005".

(b) AMENDMENT OF 1986 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

(c) TABLE OF CONTENTS.—The table of contents for this Act is as follows:

Sec. 1. Short title, etc.

TITLE I—EXTENSION AND MODIFICATION OF CERTAIN PROVISIONS

Sec. 101. Increased expensing for small business.
Sec. 102. Capital gains and dividends rates.
Sec. 103. Controlled foreign corporations.

TITLE II—OTHER PROVISIONS

Sec. 201. Clarification of taxation of certain settlement funds.
Sec. 202. Modification of active business definition under section 355.
Sec. 203. Veterans' mortgage bonds.
Sec. 204. Capital gains treatment for certain self-created musical works.
Sec. 205. Vessel tonnage limit.
Sec. 206. Modification of special arbitrage rule for certain funds.
Sec. 207. Amortization of expenses incurred in creating or acquiring music or music copyrights.
Sec. 208. Modification of effective date of disregard of certain capital expenditures for purposes of qualified small issue bonds.
Sec. 209. Modification of treatment of loans to qualified continuing care facilities.

TITLE III—ALTERNATIVE MINIMUM TAX RELIEF

Sec. 301. Increase in alternative minimum tax exemption amount for 2006.
Sec. 302. Allowance of nonrefundable personal credits against regular and alternative minimum tax liability.

TITLE IV—CORPORATE ESTIMATED TAX PROVISIONS

Sec. 401. Time for payment of corporate estimated taxes.

TITLE V—REVENUE OFFSET PROVISIONS

Sec. 501. Application of earnings stripping rules to partners which are corporations.
Sec. 502. Reporting of interest on tax-exempt bonds.
Sec. 503. 5-year amortization of geological and geophysical expenditures for certain major integrated oil companies.
Sec. 504. Application of FIRPTA to regulated investment companies.
Sec. 505. Treatment of distributions attributable to FIRPTA gains.
Sec. 506. Prevention of avoidance of tax on investments of foreign persons in United States real property through wash sale transactions.
Sec. 507. Section 355 not to apply to distributions involving disqualified investment companies.
Sec. 508. Loan and redemption requirements on pooled financing requirements.
Sec. 509. Partial payments required with submission of offers-in-compromise.
Sec. 510. Increase in age of minor children whose unearned income is taxed as if parent's income.
Sec. 511. Imposition of withholding on certain payments made by government entities.
Sec. 512. Conversions to Roth IRAs.
Sec. 513. Repeal of FSC/ETI binding contract relief.
Sec. 514. Only wages attributable to domestic production taken into account in determining deduction for domestic production.
Sec. 515. Modification of exclusion for citizens living abroad.
Sec. 516. Tax involvement of accommodation parties in tax shelter transactions.

TITLE I—EXTENSION AND MODIFICATION OF CERTAIN PROVISIONS

SEC. 101. INCREASED EXPENSING FOR SMALL BUSINESS.

Subsections (b)(1), (b)(2), (b)(5), (c)(2), and (d)(1)(A)(ii) of section 179 (relating to election to expense certain depreciable business assets) are each amended by striking "2008" and inserting "2010".

SEC. 102. CAPITAL GAINS AND DIVIDENDS RATES.

Section 303 of the Jobs and Growth Tax Relief Reconciliation Act of 2003 is amended by striking "December 31, 2008" and inserting "December 31, 2010".

SEC. 103. CONTROLLED FOREIGN CORPORATIONS.

(a) SUBPART F EXCEPTION FOR ACTIVE FINANCING.—

(1) EXEMPT INSURANCE INCOME.—Paragraph (10) of section 953(e) (relating to application) is amended—

(A) by striking "January 1, 2007" and inserting "January 1, 2009", and

(B) by striking "December 31, 2006" and inserting "December 31, 2008".

(2) EXCEPTION TO TREATMENT AS FOREIGN PERSONAL HOLDING COMPANY INCOME.—Paragraph (9) of section 954(h) (relating to application) is amended by striking "January 1, 2007" and inserting "January 1, 2009".

(b) LOOK-THROUGH TREATMENT OF PAYMENTS BETWEEN RELATED CONTROLLED FOREIGN CORPORATIONS UNDER THE FOREIGN PERSONAL HOLDING COMPANY RULES.—

(1) IN GENERAL.—Subsection (c) of section 954 (relating to foreign personal holding company income) is amended by adding at the end the following new paragraph:

"(6) LOOK-THRU RULE FOR RELATED CONTROLLED FOREIGN CORPORATIONS.—

"(A) IN GENERAL.—For purposes of this subsection, dividends, interest, rents, and royalties received or accrued from a controlled foreign corporation which is a related person shall not be treated as foreign personal holding company income to the extent attributable or properly allocable (determined under rules similar to the rules of subparagraphs (C) and (D) of section 904(d)(3)) to income of the related person which is not subpart F income. For purposes of this subparagraph, interest shall include factoring income which is treated as income equivalent to interest for purposes of paragraph (1)(E). The Secretary shall prescribe such regulations as may be appropriate to prevent the abuse of the purposes of this paragraph.

"(B) APPLICATION.—Subparagraph (A) shall apply to taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.".

(2) EFFECTIVE DATE.—The amendment made by this subsection shall apply to taxable years of foreign corporations beginning after December 31, 2005, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

TITLE II—OTHER PROVISIONS

SEC. 201. CLARIFICATION OF TAXATION OF CERTAIN SETTLEMENT FUNDS.

(a) IN GENERAL.—Subsection (g) of section 468B (relating to clarification of taxation of certain funds) is amended to read as follows:

"(g) CLARIFICATION OF TAXATION OF CERTAIN FUNDS.—

"(1) IN GENERAL.—Except as provided in paragraph (2), nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. The Secretary shall prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise.

"(2) EXEMPTION FROM TAX FOR CERTAIN SETTLEMENT FUNDS.—An escrow account, settlement fund, or similar fund shall be treated as beneficially owned by the United States and shall be exempt from taxation under this subtitle if—

"(A) it is established pursuant to a consent decree entered by a judge of a United States District Court,

"(B) it is created for the receipt of settlement payments as directed by a government entity for the sole purpose of resolving or satisfying one or more claims asserting liability under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980,

"(C) the authority and control over the expenditure of funds therein (including the expenditure of contributions thereto and any net earnings thereon) is with such government entity, and

"(D) upon termination, any remaining funds will be disbursed to such government entity for use in accordance with applicable law.

For purposes of this paragraph, the term 'government entity' means the United States, any State or political subdivision thereof, the District of Columbia, any possession of the United States, and any agency or instrumentality of any of the foregoing.

"(3) TERMINATION.—Paragraph (2) shall not apply to accounts and funds established after December 31, 2010.".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to accounts and funds established after the date of the enactment of this Act.

SEC. 202. MODIFICATION OF ACTIVE BUSINESS DEFINITION UNDER SECTION 355.

Subsection (b) of section 355 (defining active conduct of a trade or business) is amended by adding at the end the following new paragraph:

"(3) SPECIAL RULE RELATING TO ACTIVE BUSINESS REQUIREMENT.—

"(A) IN GENERAL.—In the case of any distribution made after the date of the enactment of this paragraph and on or before December 31, 2010, a corporation shall be treated as meeting the requirement of paragraph (2)(A) if and only if such corporation is engaged in the active conduct of a trade or business.

"(B) AFFILIATED GROUP RULE.—For purposes of subparagraph (A), all members of such corporation's separate affiliated group shall be treated as one corporation. For purposes of the preceding sentence, a corporation's separate affiliated group is the affiliated group which would be determined under section 1504(a) if such corporation were the common parent and section 1504(b) did not apply.

"(C) TRANSITION RULE.—Subparagraph (A) shall not apply to any distribution pursuant to a transaction which is—

"(i) made pursuant to an agreement which was binding on the date of the enactment of this paragraph and at all times thereafter,

"(ii) described in a ruling request submitted to the Internal Revenue Service on or before such date, or

"(iii) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission.

The preceding sentence shall not apply if the distributing corporation elects not to have such sentence apply to distributions of such corporation. Any such election, once made, shall be irrevocable.

"(D) SPECIAL RULE FOR CERTAIN PRE-ENACTMENT DISTRIBUTIONS.—For purposes of determining the continued qualification under paragraph (2)(A) of distributions made on or before the date of the enactment of this paragraph as a result of an acquisition, disposition, or other restructuring after such date and on or before December 31, 2010, such distribution shall be treated as made on the date of such acquisition, disposition, or restructuring for purposes of applying subparagraphs (A) through (C) of this paragraph.".

SEC. 203. VETERANS' MORTGAGE BONDS.

(a) EXPANSION OF DEFINITION OF VETERANS ELIGIBLE FOR STATE HOME LOAN PROGRAMS FUNDED BY QUALIFIED VETERANS' MORTGAGE BONDS.—

(1) IN GENERAL.—Paragraph (4) of section 143(l) (defining qualified veteran) is amended to read as follows:

"(4) QUALIFIED VETERAN.—For purposes of this subsection, the term 'qualified veteran' means—

"(A) in the case of the States of Alaska, Oregon, and Wisconsin, any veteran—

"(i) who served on active duty, and

"(ii) who applied for the financing before the date 25 years after the last date on which such veteran left active service, and

"(B) in the case of any other State, any veteran—

"(i) who served on active duty at some time before January 1, 1977, and

"(ii) who applied for the financing before the later of—

"(I) the date 30 years after the last date on which such veteran left active service, or

"(II) January 31, 1985.".

(2) EFFECTIVE DATE.—The amendments made by this subsection shall apply to bonds issued on or after the date of the enactment of this Act.

(b) REVISION OF STATE VETERANS LIMIT.—

(1) IN GENERAL.—Subparagraph (B) of section 143(l)(3) (relating to volume limitation) is amended—

(A) by redesignating clauses (i) and (ii) as subclauses (I) and (II), respectively, and moving such clauses 2 ems to the right,

(B) by amending the matter preceding subclause (I), as designated by subparagraph (A), to read as follows:

"(B) STATE VETERANS LIMIT.—

"(i) IN GENERAL.—In the case of any State to which clause (ii) does not apply, the State veterans limit for any calendar year is the amount equal to—", and

(C) by adding at the end the following new clauses:

"(ii) ALASKA, OREGON, AND WISCONSIN.—In the case of the following States, the State veterans limit for any calendar year is the amount equal to—

"(I) $25,000,000 for the State of Alaska,

"(II) $25,000,000 for the State of Oregon, and

"(III) $25,000,000 for the State of Wisconsin.

"(iii) PHASEIN.—In the case of calendar years beginning before 2010, clause (ii) shall be applied by substituting for each of the dollar amounts therein an amount equal to the applicable percentage of such dollar amount. For purposes of the preceding sentence, the applicable percentage shall be determined in accordance with the following table:

"For Calendar Year:	***Applicable percentage is:***
2006	*20 percent*
2007	*40 percent*
2008	*60 percent*
2009	*80 percent.*

"(iv) TERMINATION.—The State veterans limit for the States specified in clause (ii) for any calendar year after 2010 is zero.".

(2) EFFECTIVE DATE.—The amendments made by this subsection shall apply to allocations of State volume limit after April 5, 2006.

SEC. 204. CAPITAL GAINS TREATMENT FOR CERTAIN SELF-CREATED MUSICAL WORKS.

(a) IN GENERAL.—Subsection (b) of section 1221 (relating to capital asset defined) is amended by redesignating paragraph (3) as paragraph (4) and by inserting after paragraph (2) the following new paragraph:

"(3) SALE OR EXCHANGE OF SELF-CREATED MUSICAL WORKS.—At the election of the taxpayer, paragraphs (1) and (3) of subsection (a) shall not apply to musical compositions or copyrights in musical works sold or exchanged before January 1, 2011, by a taxpayer described in subsection (a)(3).".

(b) LIMITATION ON CHARITABLE CONTRIBUTIONS.—Subparagraph (A) of section 170(e)(1) is amended by inserting "(determined without regard to section 1221(b)(3))" after "long-term capital gain".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to sales and exchanges in taxable years beginning after the date of the enactment of this Act.

SEC. 205. VESSEL TONNAGE LIMIT.

(a) IN GENERAL.—Paragraph (4) of section 1355(a) (relating to qualifying vessel) is amended by inserting "(6,000, in the case of taxable years beginning after December 31, 2005, and ending before January 1, 2011)" after "10,000".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 2005.

SEC. 206. MODIFICATION OF SPECIAL ARBITRAGE RULE FOR CERTAIN FUNDS.

In the case of bonds issued after the date of the enactment of this Act and before August 31, 2009—

(1) the requirement of paragraph (1) of section 648 of the Deficit Reduction Act of 1984 (98 Stat. 941) shall be treated as met with respect to the securities or obligations referred to in such section if such securities or obligations are held in a fund the annual distributions from which cannot exceed 7 percent of the average fair market value of the assets held in such fund except to the extent distributions are necessary to pay debt service on the bond issue, and

(2) paragraph (3) of such section shall be applied by substituting "distributions from" for "the investment earnings of" both places it appears.

SEC. 207. AMORTIZATION OF EXPENSES INCURRED IN CREATING OR ACQUIRING MUSIC OR MUSIC COPYRIGHTS.

(a) IN GENERAL.—Section 167(g) (relating to depreciation under income forecast method) is amended by adding at the end the following new paragraph:

"(8) SPECIAL RULES FOR CERTAIN MUSICAL WORKS AND COPYRIGHTS.—

"(A) IN GENERAL.—If an election is in effect under this paragraph for any taxable year, then, notwithstanding paragraph (1), any expense which—

"(i) is paid or incurred by the taxpayer in creating or acquiring any applicable musical property placed in service during the taxable year, and

"(ii) is otherwise properly chargeable to capital account,

shall be amortized ratably over the 5-year period beginning with the month in which the property was placed in service. The preceding sentence shall not apply to any expense which, without regard to this paragraph, would not be allowable as a deduction.

"(B) EXCLUSIVE METHOD.—Except as provided in this paragraph, no depreciation or amortization deduction shall be allowed with respect to any expense to which subparagraph (A) applies.

"(C) APPLICABLE MUSICAL PROPERTY.—For purposes of this paragraph—

"(i) IN GENERAL.—The term 'applicable musical property' means any musical composition (including any accompanying words), or any copyright with respect to a musical composition, which is property to which this subsection applies without regard to this paragraph.

"(ii) EXCEPTIONS.—Such term shall not include any property—

"(I) with respect to which expenses are treated as qualified creative expenses to which section 263A(h) applies,

"(II) to which a simplified procedure established under section 263A(j)(2) applies, or

"(III) which is an amortizable section 197 intangible (as defined in section 197(c)).

"(D) ELECTION.—An election under this paragraph shall be made at such time and in such form as the Secretary may prescribe and shall apply to all applicable musical property placed in service during the taxable year for which the election applies.

"(E) TERMINATION.—An election may not be made under this paragraph for any taxable year beginning after December 31, 2010.".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to expenses paid or incurred with respect to property placed in service in taxable years beginning after December 31, 2005.

SEC. 208. MODIFICATION OF EFFECTIVE DATE OF DISREGARD OF CERTAIN CAPITAL EXPENDITURES FOR PURPOSES OF QUALIFIED SMALL ISSUE BONDS.

(a) IN GENERAL.—Section 144(a)(4)(G) is amended by striking "September 30, 2009" and inserting "December 31, 2006".

(b) CONFORMING AMENDMENT.—Section 144(a)(4)(F) is amended by striking "September 30, 2009" and inserting "December 31, 2006".

SEC. 209. MODIFICATION OF TREATMENT OF LOANS TO QUALIFIED CONTINUING CARE FACILITIES.

(a) IN GENERAL.—Section 7872 is amended by redesignating subsection (h) as subsection (i) and inserting after subsection (g) the following new subsection:

"(h) EXCEPTION FOR LOANS TO QUALIFIED CONTINUING CARE FACILITIES.—

"(1) IN GENERAL.—This section shall not apply for any calendar year to any below-market loan owed by a facility which on the last day of such year is a qualified continuing care facility, if such loan was made pursuant to a continuing care contract and if the lender (or the lender's spouse) attains age 62 before the close of such year.

"(2) CONTINUING CARE CONTRACT.—For purposes of this section, the term 'continuing care contract' means a written contract between an individual and a qualified continuing care facility under which—

"(A) the individual or individual's spouse may use a qualified continuing care facility for their life or lives,

"(B) the individual or 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

"(C) the individual or individual's spouse will be provided assisted living or nursing care as the health of such individual or individual's spouse requires, and as is available in the continuing care facility.

The Secretary shall issue guidance which limits such term to contracts which provide only facilities, care, and services described in this paragraph.

"(3) QUALIFIED CONTINUING CARE FACILITY.—

"(A) IN GENERAL.—For purposes of this section, the term 'qualified continuing care facility' means 1 or more facilities—

"(i) which are designed to provide services under continuing care contracts,

"(ii) which include an independent living unit, plus an assisted living or nursing facility, or both, and

"(iii) substantially all of the independent living unit residents of which are covered by continuing care contracts.

"(B) NURSING HOMES EXCLUDED.—The term 'qualified continuing care facility' shall not include any facility which is of a type which is traditionally considered a nursing home.

"(4) TERMINATION.—This subsection shall not apply to any calendar year after 2010.".

(b) CONFORMING AMENDMENTS.—

(1) Section 7872(g) is amended by adding at the end the following new paragraph:

"(6) SUSPENSION OF APPLICATION.—Paragraph (1) shall not apply for any calendar year to which subsection (h) applies.".

(2) Section 142(d)(2)(B) is amended by striking "Section 7872(g)" and inserting "Subsections (g) and (h) of section 7872".

(c) EFFECTIVE DATE.—The amendment made by this section shall apply to calendar years beginning after December 31, 2005, with respect to loans made before, on, or after such date.

TITLE III—ALTERNATIVE MINIMUM TAX RELIEF

SEC. 301. INCREASE IN ALTERNATIVE MINIMUM TAX EXEMPTION AMOUNT FOR 2006.

(a) IN GENERAL.—Section 55(d)(1) (relating to exemption amount for taxpayers other than corporations) is amended—

(1) by striking "$58,000" and all that follows through "2005" in subparagraph (A) and inserting "$62,550 in the case of taxable years beginning in 2006", and

(2) by striking "$40,250" and all that follows through "2005" in subparagraph (B) and inserting "$42,500 in the case of taxable years beginning in 2006".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2005.

SEC. 302. ALLOWANCE OF NONREFUNDABLE PERSONAL CREDITS AGAINST REGULAR AND ALTERNATIVE MINIMUM TAX LIABILITY.

(a) IN GENERAL.—Paragraph (2) of section 26(a) is amended—

(1) by striking "2005" in the heading thereof and inserting "2006", and

(2) by striking "or 2005" and inserting "2005, or 2006".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2005.

TITLE IV—CORPORATE ESTIMATED TAX PROVISIONS

SEC. 401. TIME FOR PAYMENT OF CORPORATE ESTIMATED TAXES.

Notwithstanding section 6655 of the Internal Revenue Code of 1986—

(1) in the case of a corporation with assets of not less than $1,000,000,000 (determined as of the end of the preceding taxable year)—

(A) the amount of any required installment of corporate estimated tax which is otherwise due in July, August, or September of 2006 shall be 105 percent of such amount,

(B) the amount of any required installment of corporate estimated tax which is otherwise due in July, August, or September of 2012 shall be 106.25 percent of such amount,

(C) the amount of any required installment of corporate estimated tax which is otherwise due in July, August, or September of 2013 shall be 100.75 percent of such amount, and

(D) the amount of the next required installment after an installment referred to in subparagraph (A), (B), or (C) shall be appropriately reduced to reflect the amount of the increase by reason of such subparagraph,

(2) 20.5 percent of the amount of any required installment of corporate estimated tax which is otherwise due in September 2010 shall not be due until October 1, 2010, and

(3) 27.5 percent of the amount of any required installment of corporate estimated tax which is otherwise due in September 2011 shall not be due until October 1, 2011.

TITLE V—REVENUE OFFSET PROVISIONS

SEC. 501. APPLICATION OF EARNINGS STRIPPING RULES TO PARTNERS WHICH ARE CORPORATIONS.

(a) IN GENERAL.—Section 163(j) (relating to limitation on deduction for interest on certain indebtedness) is amended by redesignating paragraph (8) as paragraph (9) and by inserting after paragraph (7) the following new paragraph:

"(8) TREATMENT OF CORPORATE PARTNERS.—Except to the extent provided by regulations, in applying this subsection to a corporation which owns (directly or indirectly) an interest in a partnership—

"(A) such corporation's distributive share of interest income paid or accrued to such partnership shall be treated as interest income paid or accrued to such corporation,

"(B) such corporation's distributive share of interest paid or accrued by such partnership shall be treated as interest paid or accrued by such corporation, and

"(C) such corporation's share of the liabilities of such partnership shall be treated as liabilities of such corporation.".

(b) ADDITIONAL REGULATORY AUTHORITY.—Section 163(j)(9) (relating to regulations), as redesignated by subsection (a), is amended by striking "and" at the end of subparagraph (B), by striking the period at the end of subparagraph (C) and inserting ", and", and by adding at the end the following new subparagraph:

"(D) regulations providing for the reallocation of shares of partnership indebtedness, or distributive shares of the partnership's interest income or interest expense.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning on or after the date of the enactment of this Act.

SEC. 502. REPORTING OF INTEREST ON TAX-EXEMPT BONDS.

(a) IN GENERAL.—Section 6049(b)(2) (relating to exceptions) is amended by striking subparagraph (B) and by redesignating subparagraphs (C) and (D) as subparagraphs (B) and (C), respectively.

(b) CONFORMING AMENDMENT.—Section 6049(b)(2)(C), as redesignated by subsection (a), is amended by striking "subparagraph (C)" and inserting "subparagraph (B)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to interest paid after December 31, 2005.

SEC. 503. 5-YEAR AMORTIZATION OF GEOLOGICAL AND GEOPHYSICAL EXPENDITURES FOR CERTAIN MAJOR INTEGRATED OIL COMPANIES.

(a) IN GENERAL.—Section 167(h) (relating to amortization of geological and geophysical expenditures) is amended by adding at the end the following new paragraph:

"(5) SPECIAL RULE FOR MAJOR INTEGRATED OIL COMPANIES.—

"(A) IN GENERAL.—In the case of a major integrated oil company, paragraphs (1) and (4) shall be applied by substituting '5-year' for '24 month'.

"(B) MAJOR INTEGRATED OIL COMPANY.—For purposes of this paragraph, the term 'major integrated oil company' means, with respect to any taxable year, a producer of crude oil—

"(i) which has an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year,

"(ii) which had gross receipts in excess of $1,000,000,000 for its last taxable year ending during calendar year 2005, and

"(iii) to which subsection (c) of section 613A does not apply by reason of paragraph (4) of section 613A(d), determined—

"(I) by substituting '15 percent' for '5 percent' each place it occurs in paragraph (3) of section 613A(d), and

"(II) without regard to whether subsection (c) of section 613A does not apply by reason of paragraph (2) of section 613A(d).

For purposes of clauses (i) and (ii), all persons treated as a single employer under subsections (a) and (b) of section

52 shall be treated as 1 person and, in case of a short taxable year, the rule under section 448(c)(3)(B) shall apply.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to amounts paid or incurred after the date of the enactment of this Act.

SEC. 504. APPLICATION OF FIRPTA TO REGULATED INVESTMENT COMPANIES.

(a) IN GENERAL.—Subclause (II) of section 897(h)(4)(A)(i) (defining qualified investment entity) is amended by inserting "which is a United States real property holding corporation or which would be a United States real property holding corporation if the exceptions provided in subsections (c)(3) and (h)(2) did not apply to interests in any real estate investment trust or regulated investment company" after "regulated investment company".

(b) EFFECTIVE DATE.—The amendment made by this section shall take effect as if included in the provisions of section 411 of the American Jobs Creation Act of 2004 to which it relates.

SEC. 505. TREATMENT OF DISTRIBUTIONS ATTRIBUTABLE TO FIRPTA GAINS.

(a) QUALIFIED INVESTMENT ENTITY.—

(1) IN GENERAL.—Section 897(h)(1) is amended—

(A) by striking "a nonresident alien individual or a foreign corporation" in the first sentence and inserting "a nonresident alien individual, a foreign corporation, or other qualified investment entity",

(B) by striking "such nonresident alien individual or foreign corporation" in the first sentence and inserting "such nonresident alien individual, foreign corporation, or other qualified investment entity", and

(C) by striking the second sentence and inserting the following new sentence: "Notwithstanding the preceding sentence, any distribution by a qualified investment entity to a nonresident alien individual or a foreign corporation with respect to any class of stock which is regularly traded on an established securities market located in the United States shall not be treated as gain recognized from the sale or exchange of a United States real property interest if such individual or corporation did not own more than 5 percent of such class of stock at any time during the 1-year period ending on the date of such distribution.".

(2) EXCEPTION TO TERMINATION OF APPLICATION OF SECTION 897 RULES TO REGULATED INVESTMENT COMPANIES.—Clause (ii) of section 897(h)(4)(A) is amended by adding at the end the following new sentence: "Notwithstanding the preceding sentence, an entity described in clause (i)(II) shall be treated as a qualified investment entity for purposes of applying paragraphs (1) and (5) and section 1445 with respect to any distribution by the entity to a nonresident alien individual or a foreign corporation which is attributable directly or indirectly to a distribution to the entity from a real estate investment trust.".

(b) WITHHOLDING ON DISTRIBUTIONS TREATED AS GAIN FROM UNITED STATES REAL PROPERTY INTERESTS.—Section 1445(e) (relating to special rules for distributions, etc. by corporations, partnerships, trusts, or estates) is amended by redesignating paragraph

(6) as paragraph (7) and by inserting after paragraph (5) the following new paragraph:

"(6) DISTRIBUTIONS BY REGULATED INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUSTS.—If any portion of a distribution from a qualified investment entity (as defined in section 897(h)(4)) to a nonresident alien individual or a foreign corporation is treated under section 897(h)(1) as gain realized by such individual or corporation from the sale or exchange of a United States real property interest, the qualified investment entity shall deduct and withhold under subsection (a) a tax equal to 35 percent (or, to the extent provided in regulations, 15 percent (20 percent in the case of taxable years beginning after December 31, 2010)) of the amount so treated.".

(c) TREATMENT OF CERTAIN DISTRIBUTIONS AS DIVIDENDS.—

(1) IN GENERAL.—Section 852(b)(3) (relating to capital gains) is amended by adding at the end the following new subparagraph:

"(E) CERTAIN DISTRIBUTIONS.—In the case of a distribution to which section 897 does not apply by reason of the second sentence of section 897(h)(1), the amount of such distribution which would be included in computing long-term capital gains for the shareholder under subparagraph (B) or (D) (without regard to this subparagraph)—

"(i) shall not be included in computing such shareholder's long-term capital gains, and

"(ii) shall be included in such shareholder's gross income as a dividend from the regulated investment company.".

(2) CONFORMING AMENDMENT.—Section 871(k)(2) (relating to short-term capital gain dividends) is amended by adding at the end the following new subparagraph:

"(E) CERTAIN DISTRIBUTIONS.—In the case of a distribution to which section 897 does not apply by reason of the second sentence of section 897(h)(1), the amount which would be treated as a short-term capital gain dividend to the shareholder (without regard to this subparagraph)—

"(i) shall not be treated as a short-term capital gain dividend, and

"(ii) shall be included in such shareholder's gross income as a dividend from the regulated investment company.".

(d) EFFECTIVE DATES.—The amendments made by this section shall apply to taxable years of qualified investment entities beginning after December 31, 2005, except that no amount shall be required to be withheld under section 1441, 1442, or 1445 of the Internal Revenue Code of 1986 with respect to any distribution before the date of the enactment of this Act if such amount was not otherwise required to be withheld under any such section as in effect before such amendments.

SEC. 506. PREVENTION OF AVOIDANCE OF TAX ON INVESTMENTS OF FOREIGN PERSONS IN UNITED STATES REAL PROPERTY THROUGH WASH SALE TRANSACTIONS.

(a) IN GENERAL.—Section 897(h) (relating to special rules for certain investment entities) is amended by adding at the end the following new paragraph:

"(5) TREATMENT OF CERTAIN WASH SALE TRANSACTIONS.—

"(A) IN GENERAL.—If an interest in a domestically controlled qualified investment entity is disposed of in an applicable wash sale transaction, the taxpayer shall, for purposes of this section, be treated as having gain from the sale or exchange of a United States real property interest in an amount equal to the portion of the distribution described in subparagraph (B) with respect to such interest which, but for the disposition, would have been treated by the taxpayer as gain from the sale or exchange of a United States real property interest under paragraph (1).

"(B) APPLICABLE WASH SALES TRANSACTION.—For purposes of this paragraph—

"(i) IN GENERAL.—The term 'applicable wash sales transaction' means any transaction (or series of transactions) under which a nonresident alien individual, foreign corporation, or qualified investment entity—

"(I) disposes of an interest in a domestically controlled qualified investment entity during the 30-day period preceding the ex-dividend date of a distribution which is to be made with respect to the interest and any portion of which, but for the disposition, would have been treated by the taxpayer as gain from the sale or exchange of a United States real property interest under paragraph (1), and

"(II) acquires, or enters into a contract or option to acquire, a substantially identical interest in such entity during the 61-day period beginning with the 1st day of the 30-day period described in subclause (I).

For purposes of subclause (II), a nonresident alien individual, foreign corporation, or qualified investment entity shall be treated as having acquired any interest acquired by a person related (within the meaning of section 267(b) or 707(b)(1)) to the individual, corporation, or entity, and any interest which such person has entered into any contract or option to acquire.

"(ii) APPLICATION TO SUBSTITUTE DIVIDEND AND SIMILAR PAYMENTS.—Subparagraph (A) shall apply to—

"(I) any substitute dividend payment (within the meaning of section 861), or

"(II) any other similar payment specified in regulations which the Secretary determines necessary to prevent avoidance of the purposes of this paragraph.

The portion of any such payment treated by the taxpayer as gain from the sale or exchange of a United States real property interest under subparagraph (A) by reason of this clause shall be equal to the portion of the distribution such payment is in lieu of which would have been so treated but for the transaction giving rise to such payment.

"(iii) EXCEPTION WHERE DISTRIBUTION ACTUALLY RECEIVED.—A transaction shall not be treated as an applicable wash sales transaction if the nonresident alien individual, foreign corporation, or qualified investment entity receives the distribution described in clause (i)(I) with respect to either the interest which was disposed of, or acquired, in the transaction.

"(iv) EXCEPTION FOR CERTAIN PUBLICLY TRADED STOCK.—A transaction shall not be treated as an applicable wash sales transaction if it involves the disposition of any class of stock in a qualified investment entity which is regularly traded on an established securities market within the United States but only if the nonresident alien individual, foreign corporation, or qualified investment entity did not own more than 5 percent of such class of stock at any time during the 1-year period ending on the date of the distribution described in clause (i)(I).".

(b) NO WITHHOLDING REQUIRED.—Section 1445(b) (relating to exemptions) is amended by adding at the end the following new paragraph:

"(8) APPLICABLE WASH SALES TRANSACTIONS.—No person shall be required to deduct and withhold any amount under subsection (a) with respect to a disposition which is treated as a disposition of a United States real property interest solely by reason of section 897(h)(5).".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2005, except that such amendments shall not apply to any distribution, or substitute dividend payment, occurring before the date that is 30 days after the date of the enactment of this Act.

SEC. 507. SECTION 355 NOT TO APPLY TO DISTRIBUTIONS INVOLVING DISQUALIFIED INVESTMENT COMPANIES.

(a) IN GENERAL.—Section 355 (relating to distributions of stock and securities of a controlled corporation) is amended by adding at the end the following new subsection:

"(g) SECTION NOT TO APPLY TO DISTRIBUTIONS INVOLVING DISQUALIFIED INVESTMENT CORPORATIONS.—

"(1) IN GENERAL.—This section (and so much of section 356 as relates to this section) shall not apply to any distribution which is part of a transaction if—

"(A) either the distributing corporation or controlled corporation is, immediately after the transaction, a disqualified investment corporation, and

"(B) any person holds, immediately after the transaction, a 50-percent or greater interest in any disqualified investment corporation, but only if such person did not hold such an interest in such corporation immediately before the transaction.

"(2) DISQUALIFIED INVESTMENT CORPORATION.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'disqualified investment corporation' means any distributing or controlled corporation if the fair market value of the investment assets of the corporation is—

"(i) in the case of distributions after the end of the 1-year period beginning on the date of the enactment of this subsection, 2/3 or more of the fair market value of all assets of the corporation, and

"(ii) in the case of distributions during such 1-year period, 3/4 or more of the fair market value of all assets of the corporation.

"(B) INVESTMENT ASSETS.—

"(i) IN GENERAL.—Except as otherwise provided in this subparagraph, the term 'investment assets' means—

"(I) cash,

"(II) any stock or securities in a corporation,

"(III) any interest in a partnership,

"(IV) any debt instrument or other evidence of indebtedness,

"(V) any option, forward or futures contract, notional principal contract, or derivative,

"(VI) foreign currency, or

"(VII) any similar asset.

"(ii) EXCEPTION FOR ASSETS USED IN ACTIVE CONDUCT OF CERTAIN FINANCIAL TRADES OR BUSINESSES.—Such term shall not include any asset which is held for use in the active and regular conduct of—

"(I) a lending or finance business (within the meaning of section 954(h)(4)),

"(II) a banking business through a bank (as defined in section 581), a domestic building and loan association (within the meaning of section 7701(a)(19)), or any similar institution specified by the Secretary, or

"(III) an insurance business if the conduct of the business is licensed, authorized, or regulated by an applicable insurance regulatory body.

This clause shall only apply with respect to any business if substantially all of the income of the business is derived from persons who are not related (within the meaning of section 267(b) or 707(b)(1)) to the person conducting the business.

"(iii) EXCEPTION FOR SECURITIES MARKED TO MARKET.—Such term shall not include any security (as defined in section 475(c)(2)) which is held by a dealer in securities and to which section 475(a) applies.

"(iv) STOCK OR SECURITIES IN A 20-PERCENT CONTROLLED ENTITY.—

"(I) IN GENERAL.—Such term shall not include any stock and securities in, or any asset described in subclause (IV) or (V) of clause (i) issued by, a corporation which is a 20-percent controlled entity with respect to the distributing or controlled corporation.

"(II) LOOK-THRU RULE.—The distributing or controlled corporation shall, for purposes of applying this subsection, be treated as owning its rat-

able share of the assets of any 20-percent controlled entity.

"(III) 20-PERCENT CONTROLLED ENTITY.—For purposes of this clause, the term '20-percent controlled entity' means, with respect to any distributing or controlled corporation, any corporation with respect to which the distributing or controlled corporation owns directly or indirectly stock meeting the requirements of section 1504(a)(2), except that such section shall be applied by substituting '20 percent' for '80 percent' and without regard to stock described in section 1504(a)(4).

"(v) INTERESTS IN CERTAIN PARTNERSHIPS.—

"(I) IN GENERAL.—Such term shall not include any interest in a partnership, or any debt instrument or other evidence of indebtedness, issued by the partnership, if 1 or more of the trades or businesses of the partnership are (or, without regard to the 5-year requirement under subsection (b)(2)(B), would be) taken into account by the distributing or controlled corporation, as the case may be, in determining whether the requirements of subsection (b) are met with respect to the distribution.

"(II) LOOK-THRU RULE.—The distributing or controlled corporation shall, for purposes of applying this subsection, be treated as owning its ratable share of the assets of any partnership described in subclause (I).

"(3) 50-PERCENT OR GREATER INTEREST.—For purposes of this subsection—

"(A) IN GENERAL.—The term '50-percent or greater interest' has the meaning given such term by subsection (d)(4).

"(B) ATTRIBUTION RULES.—The rules of section 318 shall apply for purposes of determining ownership of stock for purposes of this paragraph.

"(4) TRANSACTION.—For purposes of this subsection, the term 'transaction' includes a series of transactions.

"(5) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out, or prevent the avoidance of, the purposes of this subsection, including regulations—

"(A) to carry out, or prevent the avoidance of, the purposes of this subsection in cases involving—

"(i) the use of related persons, intermediaries, pass-thru entities, options, or other arrangements, and

"(ii) the treatment of assets unrelated to the trade or business of a corporation as investment assets if, prior to the distribution, investment assets were used to acquire such unrelated assets,

"(B) which in appropriate cases exclude from the application of this subsection a distribution which does not have the character of a redemption which would be treated as a sale or exchange under section 302, and

"(C) which modify the application of the attribution rules applied for purposes of this subsection.".

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to distributions after the date of the enactment of this Act.

(2) TRANSITION RULE.—The amendments made by this section shall not apply to any distribution pursuant to a transaction which is—

(A) made pursuant to an agreement which was binding on such date of enactment and at all times thereafter,

(B) described in a ruling request submitted to the Internal Revenue Service on or before such date, or

(C) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission.

SEC. 508. LOAN AND REDEMPTION REQUIREMENTS ON POOLED FINANCING REQUIREMENTS.

(a) STRENGTHENED REASONABLE EXPECTATION REQUIREMENT.—Subparagraph (A) of section 149(f)(2) (relating to reasonable expectation requirement) is amended to read as follows:

"(A) IN GENERAL.—The requirements of this paragraph are met with respect to an issue if the issuer reasonably expects that—

"(i) as of the close of the 1-year period beginning on the date of issuance of the issue, at least 30 percent of the net proceeds of the issue (as of the close of such period) will have been used directly or indirectly to make or finance loans to ultimate borrowers, and

"(ii) as of the close of the 3-year period beginning on such date of issuance, at least 95 percent of the net proceeds of the issue (as of the close of such period) will have been so used.".

(b) WRITTEN LOAN COMMITMENT AND REDEMPTION REQUIREMENTS.—Section 149(f) (relating to treatment of certain pooled financing bonds) is amended by redesignating paragraphs (4) and (5) as paragraphs (6) and (7), respectively, and by inserting after paragraph (3) the following new paragraphs:

"(4) WRITTEN LOAN COMMITMENT REQUIREMENT.—

"(A) IN GENERAL.—The requirement of this paragraph is met with respect to an issue if the issuer receives prior to issuance written loan commitments identifying the ultimate potential borrowers of at least 30 percent of the net proceeds of such issue.

"(B) EXCEPTION.—Subparagraph (A) shall not apply with respect to any issuer which—

"(i) is a State (or an integral part of a State) issuing pooled financing bonds to make or finance loans to subordinate governmental units of such State, or

"(ii) is a State-created entity providing financing for water-infrastructure projects through the federally-sponsored State revolving fund program.

"(5) REDEMPTION REQUIREMENT.—The requirement of this paragraph is met if to the extent that less than the percentage of the proceeds of an issue required to be used under clause (i) or (ii) of paragraph (2)(A) is used by the close of the period

identified in such clause, the issuer uses an amount of proceeds equal to the excess of—

"(A) the amount required to be used under such clause, over

"(B) the amount actually used by the close of such period,

to redeem outstanding bonds within 90 days after the end of such period.".

(c) ELIMINATION OF DISREGARD OF POOLED BONDS IN DETERMINING ELIGIBILITY FOR SMALL ISSUER EXCEPTION TO ARBITRAGE REBATE.—Section 148(f)(4)(D)(ii) (relating to aggregation of issuers) is amended by striking subclause (II) and by redesignating subclauses (III) and (IV) as subclauses (II) and (III), respectively.

(d) CONFORMING AMENDMENTS.—

(1) Section 149(f)(1) is amended by striking "paragraphs (2) and (3)" and inserting "paragraphs (2), (3), (4), and (5)".

(2) Section 149(f)(7)(B), as redesignated by subsection (b), is amended by striking "paragraph (4)(A)" and inserting "paragraph (6)(A)".

(3) Section 54(l)(2) is amended by striking "section 149(f)(4)(A)" and inserting "section 149(f)(6)(A)".

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to bonds issued after the date of the enactment of this Act.

SEC. 509. PARTIAL PAYMENTS REQUIRED WITH SUBMISSION OF OFFERS-IN-COMPROMISE.

(a) IN GENERAL.—Section 7122 (relating to compromises) is amended by redesignating subsections (c) and (d) as subsections (d) and (e), respectively, and by inserting after subsection (b) the following new subsection:

"(c) RULES FOR SUBMISSION OF OFFERS-IN-COMPROMISE.—

"(1) PARTIAL PAYMENT REQUIRED WITH SUBMISSION.—

"(A) LUMP-SUM OFFERS.—

"(i) IN GENERAL.—The submission of any lump-sum offer-in-compromise shall be accompanied by the payment of 20 percent of the amount of such offer.

"(ii) LUMP-SUM OFFER-IN-COMPROMISE.—For purposes of this section, the term 'lump-sum offer-in-compromise' means any offer of payments made in 5 or fewer installments.

"(B) PERIODIC PAYMENT OFFERS.—

"(i) IN GENERAL.—The submission of any periodic payment offer-in-compromise shall be accompanied by the payment of the amount of the first proposed installment.

"(ii) FAILURE TO MAKE INSTALLMENT DURING PENDENCY OF OFFER.—Any failure to make an installment (other than the first installment) due under such offer-in-compromise during the period such offer is being evaluated by the Secretary may be treated by the Secretary as a withdrawal of such offer-in-compromise.

"(2) RULES OF APPLICATION.—

"(A) USE OF PAYMENT.—The application of any payment made under this subsection to the assessed tax or

other amounts imposed under this title with respect to such tax may be specified by the taxpayer.

"(B) APPLICATION OF USER FEE.—In the case of any assessed tax or other amounts imposed under this title with respect to such tax which is the subject of an offer-in-compromise to which this subsection applies, such tax or other amounts shall be reduced by any user fee imposed under this title with respect to such offer-in-compromise.

"(C) WAIVER AUTHORITY.—The Secretary may issue regulations waiving any payment required under paragraph (1) in a manner consistent with the practices established in accordance with the requirements under subsection (d)(3).".

(b) ADDITIONAL RULES RELATING TO TREATMENT OF OFFERS.—

(1) UNPROCESSABLE OFFER IF PAYMENT REQUIREMENTS ARE NOT MET.—Paragraph (3) of section 7122(d) (relating to standards for evaluation of offers), as redesignated by subsection (a), is amended by striking "; and" at the end of subparagraph (A) and inserting a comma, by striking the period at the end of subparagraph (B) and inserting ", and", and by adding at the end the following new subparagraph:

"(C) any offer-in-compromise which does not meet the requirements of subparagraph (A)(i) or (B)(i), as the case may be, of subsection (c)(1) may be returned to the taxpayer as unprocessable.".

(2) DEEMED ACCEPTANCE OF OFFER NOT REJECTED WITHIN CERTAIN PERIOD.—Section 7122, as amended by subsection (a), is amended by adding at the end the following new subsection:

"(f) DEEMED ACCEPTANCE OF OFFER NOT REJECTED WITHIN CERTAIN PERIOD.—Any offer-in-compromise submitted under this section shall be deemed to be accepted by the Secretary if such offer is not rejected by the Secretary before the date which is 24 months after the date of the submission of such offer. For purposes of the preceding sentence, any period during which any tax liability which is the subject of such offer-in-compromise is in dispute in any judicial proceeding shall not be taken into account in determining the expiration of the 24-month period.".

(c) CONFORMING AMENDMENT.—Section 6159(f) is amended by striking "section 7122(d)" and inserting "section 7122(e)".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to offers-in-compromise submitted on and after the date which is 60 days after the date of the enactment of this Act.

SEC. 510. INCREASE IN AGE OF MINOR CHILDREN WHOSE UNEARNED INCOME IS TAXED AS IF PARENT'S INCOME.

(a) IN GENERAL.—Section 1(g)(2)(A) (relating to child to whom subsection applies) is amended by striking "age 14" and inserting "age 18".

(b) TREATMENT OF DISTRIBUTIONS FROM QUALIFIED DISABILITY TRUSTS.—Section 1(g)(4) (relating to net unearned income) is amended by adding at the end the following new subparagraph:

"(C) TREATMENT OF DISTRIBUTIONS FROM QUALIFIED DISABILITY TRUSTS.—For purposes of this subsection, in the case of any child who is a beneficiary of a qualified disability trust (as defined in section 642(b)(2)(C)(ii)), any amount included in the income of such child under sections

652 and 662 during a taxable year shall be considered earned income of such child for such taxable year.".

(c) CONFORMING AMENDMENT.—Section 1(g)(2) is amended by striking "and" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", and", and by inserting after subparagraph (B) the following new subparagraph:

"(C) such child does not file a joint return for the taxable year.".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2005.

SEC. 511. IMPOSITION OF WITHHOLDING ON CERTAIN PAYMENTS MADE BY GOVERNMENT ENTITIES.

(a) IN GENERAL.—Section 3402 is amended by adding at the end the following new subsection:

"(t) EXTENSION OF WITHHOLDING TO CERTAIN PAYMENTS MADE BY GOVERNMENT ENTITIES.—

"(1) GENERAL RULE.—The Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies) making any payment to any person providing any property or services (including any payment made in connection with a government voucher or certificate program which functions as a payment for property or services) shall deduct and withhold from such payment a tax in an amount equal to 3 percent of such payment.

"(2) PROPERTY AND SERVICES SUBJECT TO WITHHOLDING.—Paragraph (1) shall not apply to any payment—

"(A) except as provided in subparagraph (B), which is subject to withholding under any other provision of this chapter or chapter 3,

"(B) which is subject to withholding under section 3406 and from which amounts are being withheld under such section,

"(C) of interest,

"(D) for real property,

"(E) to any governmental entity subject to the requirements of paragraph (1), any tax-exempt entity, or any foreign government,

"(F) made pursuant to a classified or confidential contract described in section 6050M(e)(3),

"(G) made by a political subdivision of a State (or any instrumentality thereof) which makes less than $100,000,000 of such payments annually,

"(H) which is in connection with a public assistance or public welfare program for which eligibility is determined by a needs or income test, and

"(I) to any government employee not otherwise excludable with respect to their services as an employee.

"(3) COORDINATION WITH OTHER SECTIONS.—For purposes of sections 3403 and 3404 and for purposes of so much of subtitle F (except section 7205) as relates to this chapter, payments to any person for property or services which are subject to withholding shall be treated as if such payments were wages paid by an employer to an employee.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to payments made after December 31, 2010.

SEC. 512. CONVERSIONS TO ROTH IRAS.

(a) REPEAL OF INCOME LIMITATIONS.—

(1) IN GENERAL.—Paragraph (3) of section 408A(c) (relating to limits based on modified adjusted gross income) is amended by striking subparagraph (B) and redesignating subparagraphs (C) and (D) as subparagraphs (B) and (C), respectively.

(2) CONFORMING AMENDMENT.—Clause (i) of section 408A(c)(3)(B) (as redesignated by paragraph (1)) is amended by striking "except that—" and all that follows and inserting "except that any amount included in gross income under subsection (d)(3) shall not be taken into account, and".

(b) ROLLOVERS TO A ROTH IRA FROM AN IRA OTHER THAN A ROTH IRA.—

(1) IN GENERAL.—Clause (iii) of section 408A(d)(3)(A) (relating to rollovers from an IRA other than a Roth IRA) is amended to read as follows:

> *"(iii) unless the taxpayer elects not to have this clause apply, any amount required to be included in gross income for any taxable year beginning in 2010 by reason of this paragraph shall be so included ratably over the 2-taxable-year period beginning with the first taxable year beginning in 2011.".*

(2) CONFORMING AMENDMENTS.—

(A) Clause (i) of section 408A(d)(3)(E) is amended to read as follows:

> *"(i) ACCELERATION OF INCLUSION.—*
>
> *"(I) IN GENERAL.—The amount otherwise required to be included in gross income for any taxable year beginning in 2010 or the first taxable year in the 2-year period under subparagraph (A)(iii) shall be increased by the aggregate distributions from Roth IRAs for such taxable year which are allocable under paragraph (4) to the portion of such qualified rollover contribution required to be included in gross income under subparagraph (A)(i).*
>
> *"(II) LIMITATION ON AGGREGATE AMOUNT INCLUDED.—The amount required to be included in gross income for any taxable year under subparagraph (A)(iii) shall not exceed the aggregate amount required to be included in gross income under subparagraph (A)(iii) for all taxable years in the 2-year period (without regard to subclause (I)) reduced by amounts included for all preceding taxable years.".*

(B) The heading for section 408A(d)(3)(E) is amended by striking "4-YEAR" and inserting "2-YEAR".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2009.

SEC. 513. REPEAL OF FSC/ETI BINDING CONTRACT RELIEF.

(a) FSC PROVISIONS.—Paragraph (1) of section 5(c) of the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 is amend-

ed by striking "which occurs—" and all that follows and inserting "which occurs before January 1, 2002.".

(b) ETI PROVISIONS.—Section 101 of the American Jobs Creation Act of 2004 is amended by striking subsection (f).

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 514. ONLY WAGES ATTRIBUTABLE TO DOMESTIC PRODUCTION TAKEN INTO ACCOUNT IN DETERMINING DEDUCTION FOR DOMESTIC PRODUCTION.

(a) IN GENERAL.—Paragraph (2) of section 199(b) (relating to W–2 wages) is amended to read as follows:

"(2) W–2 WAGES.—For purposes of this section—

"(A) IN GENERAL.—The term 'W–2 wages' means, with respect to any person for any taxable year of such person, the sum of the amounts described in paragraphs (3) and (8) of section 6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year.

"(B) LIMITATION TO WAGES ATTRIBUTABLE TO DOMESTIC PRODUCTION.—Such term shall not include any amount which is not properly allocable to domestic production gross receipts for purposes of subsection (c)(1).

"(C) RETURN REQUIREMENT.—Such term shall not include any amount which is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return.".

(b) SIMPLIFICATION OF RULES FOR DETERMINING W–2 WAGES OF PARTNERS AND S CORPORATION SHAREHOLDERS.—

(1) IN GENERAL.—Clause (iii) of section 199(d)(1)(A) is amended to read as follows:

"(iii) each partner or shareholder shall be treated for purposes of subsection (b) as having W–2 wages for the taxable year in an amount equal to such person's allocable share of the W–2 wages of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary).".

(2) CONFORMING AMENDMENT.—Paragraph (2) of section 199(a) is amended by striking "and subsection (d)(1)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 515. MODIFICATION OF EXCLUSION FOR CITIZENS LIVING ABROAD.

(a) INFLATION ADJUSTMENT OF FOREIGN EARNED INCOME LIMITATION.—Clause (ii) of section 911(b)(2)(D) (relating to inflation adjustment) is amended—

(1) by striking "2007" and inserting "2005", and

(2) by striking "2006" in subclause (II) and inserting "2004".

(b) MODIFICATION OF HOUSING COST AMOUNT.—

(1) MODIFICATION OF HOUSING COST FLOOR.—Clause (i) of section 911(c)(1)(B) is amended to read as follows:

"(i) 16 percent of the amount (computed on a daily basis) in effect under subsection (b)(2)(D) for the calendar year in which such taxable year begins, multiplied by".

(2) MAXIMUM AMOUNT OF EXCLUSION.—

(A) IN GENERAL.—Subparagraph (A) of section 911(c)(1) is amended by inserting "to the extent such expenses do not exceed the amount determined under paragraph (2)" after "the taxable year".

(B) LIMITATION.—Subsection (c) of section 911 is amended by redesignating paragraphs (2) and (3) as paragraphs (3) and (4), respectively, and by inserting after paragraph (1) the following new paragraph:

"(2) LIMITATION.—

"(A) IN GENERAL.—The amount determined under this paragraph is an amount equal to the product of—

"(i) 30 percent (adjusted as may be provided under subparagraph (B)) of the amount (computed on a daily basis) in effect under subsection (b)(2)(D) for the calendar year in which the taxable year of the individual begins, multiplied by

"(ii) the number of days of such taxable year within the applicable period described in subparagraph (A) or (B) of subsection (d)(1).

"(B) REGULATIONS.—The Secretary may issue regulations or other guidance providing for the adjustment of the percentage under subparagraph (A)(i) on the basis of geographic differences in housing costs relative to housing costs in the United States.".

(C) CONFORMING AMENDMENTS.—

(i) Section 911(d)(4) is amended by striking "and (c)(1)(B)(ii)" and inserting ", (c)(1)(B)(ii), and (c)(2)(A)(ii)".

(ii) Section 911(d)(7) is amended by striking "subsection (c)(3)" and inserting "subsection (c)(4)".

(c) RATES OF TAX APPLICABLE TO NONEXCLUDED INCOME.—Section 911 (relating to exclusion of certain income of citizens and residents of the United States living abroad) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) DETERMINATION OF TAX LIABILITY ON NONEXCLUDED AMOUNTS.—For purposes of this chapter, if any amount is excluded from the gross income of a taxpayer under subsection (a) for any taxable year, then, notwithstanding section 1 or 55—

"(1) the tax imposed by section 1 on the taxpayer for such taxable year shall be equal to the excess (if any) of—

"(A) the tax which would be imposed by section 1 for the taxable year if the taxpayer's taxable income were increased by the amount excluded under subsection (a) for the taxable year, over

"(B) the tax which would be imposed by section 1 for the taxable year if the taxpayer's taxable income were equal to the amount excluded under subsection (a) for the taxable year, and

"(2) the tentative minimum tax under section 55 for such taxable year shall be equal to the excess (if any) of—

"(A) the amount which would be such tentative minimum tax for the taxable year if the taxpayer's taxable excess were increased by the amount excluded under subsection (a) for the taxable year, over

"(B) the amount which would be such tentative minimum tax for the taxable year if the taxpayer's taxable excess were equal to the amount excluded under subsection (a) for the taxable year.

For purposes of this subsection, the amount excluded under subsection (a) shall be reduced by the aggregate amount of any deductions or exclusions disallowed under subsection (d)(6) with respect to such excluded amount.".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2005.

SEC. 516. TAX INVOLVEMENT OF ACCOMMODATION PARTIES IN TAX SHELTER TRANSACTIONS.

(a) IMPOSITION OF EXCISE TAX.—

(1) IN GENERAL.—Chapter 42 (relating to private foundations and certain other tax-exempt organizations) is amended by adding at the end the following new subchapter:

"Subchapter F—Tax Shelter Transactions

"Sec. 4965. Excise tax on certain tax-exempt entities entering into prohibited tax shelter transactions.

"SEC. 4965. EXCISE TAX ON CERTAIN TAX-EXEMPT ENTITIES ENTERING INTO PROHIBITED TAX SHELTER TRANSACTIONS.

"(a) BEING A PARTY TO AND APPROVAL OF PROHIBITED TRANSACTIONS.—

"(1) TAX-EXEMPT ENTITY.—

"(A) IN GENERAL.—If a transaction is a prohibited tax shelter transaction at the time any tax-exempt entity described in paragraph (1), (2), or (3) of subsection (c) becomes a party to the transaction, such entity shall pay a tax for the taxable year in which the entity becomes such a party and any subsequent taxable year in the amount determined under subsection (b)(1).

"(B) POST-TRANSACTION DETERMINATION.—If any tax-exempt entity described in paragraph (1), (2), or (3) of subsection (c) is a party to a subsequently listed transaction at any time during a taxable year, such entity shall pay a tax for such taxable year in the amount determined under subsection (b)(1).

"(2) ENTITY MANAGER.—If any entity manager of a tax-exempt entity approves such entity as (or otherwise causes such entity to be) a party to a prohibited tax shelter transaction at any time during the taxable year and knows or has reason to know that the transaction is a prohibited tax shelter transaction, such manager shall pay a tax for such taxable year in the amount determined under subsection (b)(2).

"(b) AMOUNT OF TAX.—

"(1) ENTITY.—In the case of a tax-exempt entity—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the amount of the tax imposed under subsection (a)(1) with respect to any transaction for a taxable year shall be an amount equal to the product of the highest rate of tax under section 11, and the greater of—

"(i) the entity's net income (after taking into account any tax imposed by this subtitle (other than by this section) with respect to such transaction) for such taxable year which—

"(I) in the case of a prohibited tax shelter transaction (other than a subsequently listed transaction), is attributable to such transaction, or

"(II) in the case of a subsequently listed transaction, is attributable to such transaction and which is properly allocable to the period beginning on the later of the date such transaction is identified by guidance as a listed transaction by the Secretary or the first day of the taxable year, or

"(ii) 75 percent of the proceeds received by the entity for the taxable year which—

"(I) in the case of a prohibited tax shelter transaction (other than a subsequently listed transaction), are attributable to such transaction, or

"(II) in the case of a subsequently listed transaction, are attributable to such transaction and which are properly allocable to the period beginning on the later of the date such transaction is identified by guidance as a listed transaction by the Secretary or the first day of the taxable year.

"(B) INCREASE IN TAX FOR CERTAIN KNOWING TRANSACTIONS.—In the case of a tax-exempt entity which knew, or had reason to know, a transaction was a prohibited tax shelter transaction at the time the entity became a party to the transaction, the amount of the tax imposed under subsection (a)(1)(A) with respect to any transaction for a taxable year shall be the greater of—

"(i) 100 percent of the entity's net income (after taking into account any tax imposed by this subtitle (other than by this section) with respect to the prohibited tax shelter transaction) for such taxable year which is attributable to the prohibited tax shelter transaction, or

"(ii) 75 percent of the proceeds received by the entity for the taxable year which are attributable to the prohibited tax shelter transaction.

This subparagraph shall not apply to any prohibited tax shelter transaction to which a tax-exempt entity became a party on or before the date of the enactment of this section.

"(2) ENTITY MANAGER.—In the case of each entity manager, the amount of the tax imposed under subsection (a)(2) shall be $20,000 for each approval (or other act causing participation) described in subsection (a)(2).

"(c) TAX-EXEMPT ENTITY.—For purposes of this section, the term 'tax-exempt entity' means an entity which is—

"(1) described in section 501(c) or 501(d),

"(2) described in section 170(c) (other than the United States),

"(3) an Indian tribal government (within the meaning of section 7701(a)(40)),

"(4) described in paragraph (1), (2), or (3) of section 4979(e),

"(5) a program described in section 529,

"(6) an eligible deferred compensation plan described in section 457(b) which is maintained by an employer described in section 4457(e)(1)(A), or

"(7) an arrangement described in section 4973(a).

"(d) ENTITY MANAGER.—For purposes of this section, the term 'entity manager' means—

"(1) in the case of an entity described in paragraph (1), (2), or (3) of subsection (c)—

"(A) the person with authority or responsibility similar to that exercised by an officer, director, or trustee of an organization, and

"(B) with respect to any act, the person having authority or responsibility with respect to such act, and

"(2) in the case of an entity described in paragraph (4), (5), (6), or (7) of subsection (c), the person who approves or otherwise causes the entity to be a party to the prohibited tax shelter transaction.

"(e) PROHIBITED TAX SHELTER TRANSACTION; SUBSEQUENTLY LISTED TRANSACTION.—For purposes of this section—

"(1) PROHIBITED TAX SHELTER TRANSACTION.—

"(A) IN GENERAL.—The term 'prohibited tax shelter transaction' means—

"(i) any listed transaction, and

"(ii) any prohibited reportable transaction.

"(B) LISTED TRANSACTION.—The term 'listed transaction' has the meaning given such term by section 6707A(c)(2).

"(C) PROHIBITED REPORTABLE TRANSACTION.—The term 'prohibited reportable transaction' means any confidential transaction or any transaction with contractual protection (as defined under regulations prescribed by the Secretary) which is a reportable transaction (as defined in section 6707A(c)(1)).

"(2) SUBSEQUENTLY LISTED TRANSACTION.—The term 'subsequently listed transaction' means any transaction to which a tax-exempt entity is a party and which is determined by the Secretary to be a listed transaction at any time after the entity has become a party to the transaction. Such term shall not include a transaction which is a prohibited reportable transaction at the time the entity became a party to the transaction.

"(f) REGULATORY AUTHORITY.—The Secretary is authorized to promulgate regulations which provide guidance regarding the determination of the allocation of net income or proceeds of a tax-exempt entity attributable to a transaction to various periods, including before and after the listing of the transaction or the date which is 90 days after the date of the enactment of this section.

"(g) COORDINATION WITH OTHER TAXES AND PENALTIES.—The tax imposed by this section is in addition to any other tax, addition to tax, or penalty imposed under this title.".

(2) CONFORMING AMENDMENT.—The table of subchapters for chapter 42 is amended by adding at the end the following new item:

"SUBCHAPTER F. TAX SHELTER TRANSACTIONS.".

(b) DISCLOSURE REQUIREMENTS.—

(1) DISCLOSURE BY ENTITY TO THE INTERNAL REVENUE SERVICE.—

(A) IN GENERAL.—Section 6033(a) (relating to organizations required to file) is amended by redesignating paragraph (2) as paragraph (3) and by inserting after paragraph (1) the following new paragraph:

"(2) BEING A PARTY TO CERTAIN REPORTABLE TRANSACTIONS.—Every tax-exempt entity described in section 4965(c) shall file (in such form and manner and at such time as determined by the Secretary) a disclosure of—

"(A) such entity's being a party to any prohibited tax shelter transaction (as defined in section 4965(e)), and

"(B) the identity of any other party to such transaction which is known by such tax-exempt entity.".

(B) CONFORMING AMENDMENT.—Section 6033(a)(1) is amended by striking "paragraph (2)" and inserting "paragraph (3)".

(2) DISCLOSURE BY OTHER TAXPAYERS TO THE TAX-EXEMPT ENTITY.—Section 6011 (relating to general requirement of return, statement, or list) is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

"(g) DISCLOSURE OF REPORTABLE TRANSACTION TO TAX-EXEMPT ENTITY.—Any taxable party to a prohibited tax shelter transaction (as defined in section 4965(e)(1)) shall by statement disclose to any tax-exempt entity (as defined in section 4965(c)) which is a party to such transaction that such transaction is such a prohibited tax shelter transaction.".

(c) PENALTY FOR NONDISCLOSURE.—

(1) IN GENERAL.—Section 6652(c) (relating to returns by exempt organizations and by certain trusts) is amended by redesignating paragraphs (3) and (4) as paragraphs (4) and (5), respectively, and by inserting after paragraph (2) the following new paragraph:

"(3) DISCLOSURE UNDER SECTION 6033(a)(2).—

"(A) PENALTY ON ENTITIES.—In the case of a failure to file a disclosure required under section 6033(a)(2), there shall be paid by the tax-exempt entity (the entity manager in the case of a tax-exempt entity described in paragraph (4), (5), (6), or (7) of section 4965(c)) $100 for each day during which such failure continues. The maximum penalty under this subparagraph on failures with respect to any 1 disclosure shall not exceed $50,000.

"(B) WRITTEN DEMAND.—

"(i) IN GENERAL.—The Secretary may make a written demand on any entity or manager subject to penalty under subparagraph (A) specifying therein a rea-

sonable future date by which the disclosure shall be filed for purposes of this subparagraph.

"(ii) FAILURE TO COMPLY WITH DEMAND.—If any entity or manager fails to comply with any demand under clause (i) on or before the date specified in such demand, there shall be paid by such entity or manager failing to so comply $100 for each day after the expiration of the time specified in such demand during which such failure continues. The maximum penalty imposed under this subparagraph on all entities and managers for failures with respect to any 1 disclosure shall not exceed $10,000.

"(C) DEFINITIONS.—Any term used in this section which is also used in section 4965 shall have the meaning given such term under section 4965.".

(2) CONFORMING AMENDMENT.—Paragraph (1) of section 6652(c) is amended by striking "6033" each place it appears in the text and heading thereof and inserting "6033(a)(1)".

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years ending after the date of the enactment of this Act, with respect to transactions before, on, or after such date, except that no tax under section 4965(a) of the Internal Revenue Code of 1986 (as added by this section) shall apply with respect to income or proceeds that are properly allocable to any period ending on or before the date which is 90 days after such date of enactment.

(2) DISCLOSURE.—The amendments made by subsections (b) and (c) shall apply to disclosures the due date for which are after the date of the enactment of this Act.

And the Senate agree to the same.

WILLIAM THOMAS,
JIM MCCRERY,
DAVE CAMP,
Managers on the Part of the House.

CHUCK GRASSLEY,
JON KYL,
Managers on the Part of the Senate.

JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE

The managers on the part of the House and the Senate at the conference on the disagreeing votes of the two Houses on the amendment of the Senate to the bill (H.R. 4297), to provide for reconciliation pursuant to section 201(b) of the concurrent resolution on the budget for fiscal year 2006, submit the following joint statement to the House and the Senate in explanation of the effect of the action agreed upon by the managers and recommended in the accompanying conference report:

The Senate amendment struck all of the House bill after the enacting clause and inserted a substitute text.

The House recedes from its disagreement to the amendment of the Senate with an amendment that is a substitute for the House bill and the Senate amendment. The differences between the House bill, the Senate amendment, and the substitute agreed to in conference are noted below, except for clerical corrections, conforming changes made necessary by agreements reached by the conferees, and minor drafting and clarifying changes.

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TITLE I—EXTENSION AND MODIFICATION OF CERTAIN PROVISIONS

A. Allowance of Nonrefundable Personal Credits Against Regular and Alternative Minimum Tax Liability

(Sec. 101 of the House bill, sec. 107 of the Senate amendment, and sec. 26 of the Code)

PRESENT LAW

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, the credit for savers, the credit for certain nonbusiness energy property, the credit for residential energy efficient property, and the D.C. first-time homebuyer credit). The Energy Tax Incentives Act of 2005 enacted, effective for 2006, nonrefundable tax credits for alternative motor vehicles, and alternative motor vehicle refueling property.[1]

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

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

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is

[1] The portion of these credits relating to personal use property is subject to the same tax liability limitation as the nonrefundable personal tax credits (other than the adoption credit, child credit, and saver's credit).

so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments.

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

HOUSE BILL

The House bill extends for one year the present-law provision allowing nonrefundable personal credits to the full extent of the individual's regular tax and alternative minimum tax (through taxable years beginning on or before December 31, 2006).

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

SENATE AMENDMENT

The Senate amendment extends for two years the present-law provision allowing nonrefundable personal credits to the full extent of the individual's regular tax and alternative minimum tax (through taxable years beginning on or before December 31, 2007).

The provision also applies to the personal credits for alternative motor vehicles, and alternative motor vehicle refueling property.

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

CONFERENCE AGREEMENT

The conference agreement includes the House bill provision.

B. Tax Incentives for Business Activities on Indian Reservations

1. Indian employment tax credit (Sec. 102(a) of the House bill, sec. 115 of the Senate amendment, 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).[2] 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.

HOUSE BILL

The provision extends for one year the present-law employment credit provision (through taxable years beginning on or before December 31, 2006).

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

[2] All section references are to the Internal Revenue Code of 1986, unless otherwise indicated.

SENATE AMENDMENT

The Senate amendment extends for two years the present-law employment credit provision (through taxable years beginning on or before December 31, 2007).

Effective date.—Same as the House bill provision.

CONFERENCE AGREEMENT

The conference agreement does not include the House bill provision or the Senate amendment provision.

2. Accelerated depreciation for business property on Indian reservations (Sec. 102(b) of the House bill, sec. 116 of the Senate amendment, and sec. 168(j) 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:

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

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

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

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the alternative minimum tax. The accelerated depreciation for Indian reservations is available with re-

spect to property placed in service on or after January 1, 1994, and before January 1, 2006.

HOUSE BILL

The provision extends for one year the present-law incentive relating to depreciation of qualified Indian reservation property (to apply to property placed in service through December 31, 2006).

Effective date.—The provision applies to property placed in service after December 31, 2005.

SENATE AMENDMENT

The Senate amendment 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 Senate amendment is the same as the House bill.

CONFERENCE AGREEMENT

The conference agreement does not include the House bill provision or the Senate amendment provision.

C. Work Opportunity Tax Credit and Welfare-To-Work Tax Credit

(Secs. 103 and 104 of the House bill, sec. 109 of the Senate amendment 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).

Minimum employment period

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

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

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

Other rules

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

Expiration

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

Welfare-to-work tax credit

Targeted group eligible for the credit

The welfare-to-work tax credit is available on an elective basis to employers of qualified long-term family assistance recipients. Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that

has received such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of the welfare-to-work tax credit) if they are hired within 2 years after the date that the 18–month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either Federal or State time limits, if they are hired within 2 years after the Federal or State time limits made the family ineligible for family assistance.

Qualified wages

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

Calculation of the credit

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

Minimum employment period

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

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

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

Other rules

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

Expiration

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

HOUSE BILL

Work opportunity tax credit

The House bill extends the work opportunity credit for one year (through December 31, 2006). Also, the House bill raises the maximum age limit for the food stamp recipient category to include individuals who are at least age 18 but under age 35 on the hiring date.

Effective date

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

Welfare-to-work tax credit

The House bill extends the welfare-to-work tax credit for one year (through December 31, 2006).

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

SENATE AMENDMENT

In general

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

Targeted groups eligible for the combined credit

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

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

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

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

Qualified wages

Qualified first-year wages for the eight work opportunity tax credit categories remain capped at $6,000 ($3,000 for qualified summer youth employees). No credit is allowed for second-year wages. In the case of long-term family assistance recipients, the

cap is $10,000 for both qualified first-year wages and qualified second-year wages. The combined credit follows the work opportunity tax credit definition of wages which does not include amounts paid by the employer for: (1) educational assistance excludable under a section 127 program (or that would be excludable but for the expiration of sec. 127); (2) health plan coverage for the employee, but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129. For all targeted groups, the employer's deduction for wages is reduced by the amount of the credit.

Calculation of the credit

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

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

Minimum employment period

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

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

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

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

CONFERENCE AGREEMENT

The conference agreement does not include the House bill provision or the Senate amendment provision.

D. Deduction for Corporate Donations of Computer Technology and Equipment

(Sec. 105 of the House bill, sec. 111 of the Senate amendment 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.

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

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

HOUSE BILL

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

Effective date.—The provision is effective for contributions made in taxable years beginning after December 31, 2005.

SENATE AMENDMENT

Same as House bill.

Effective date.—The provision is effective on the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the House bill provision or the Senate amendment provision.

E. Availability of Archer Medical Savings Accounts

(Sec. 106 of the House 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, distributions not used for medical expenses are subject to an additional 15-percent tax unless the distribution is made after age 65, death, or disability.

Eligible individuals

Archer MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals covered under a high deductible health plan. An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year. An individual is not eligible for an Archer MSA if he or she is covered under any other health plan in addition to the high deductible plan.

Tax treatment of and limits on contributions

Individual contributions to an Archer MSA are deductible (within limits) in determining adjusted gross income (*i.e.*, "above-the-line"). In addition, employer contributions are excludable from gross income and wages for employment tax purposes (within the same limits), except that this exclusion does not apply to contributions made through a cafeteria plan. In the case of an employee, contributions can be made to an Archer MSA either by the individual or by the individual's employer.

The maximum annual contribution that can be made to an Archer MSA for a year is 65 percent of the deductible under the high

deductible plan in the case of individual coverage and 75 percent of the deductible in the case of family coverage.

Definition of high deductible plan

A high deductible plan is a health plan with an annual deductible of at least $1,800 and no more than $2,700 in the case of individual coverage and at least $3,650 and no more than $5,450 in the case of family coverage (for 2006). In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must be no more than $3,650 in the case of individual coverage and no more than $6,650 in the case of family coverage (for 2006). A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for certain permitted coverage. In the case of a self-insured plan, the plan must in fact be insurance (*e.g.*, there must be appropriate risk shifting) and not merely a reimbursement arrangement.

Cap on taxpayers utilizing Archer MSAs and expiration of pilot program

The number of taxpayers benefiting annually from an Archer MSA contribution is limited to a threshold level (generally 750,000 taxpayers). The number of Archer MSAs established has not exceeded the threshold level.

After 2005, no new contributions may be made to Archer MSAs except by or on behalf of individuals who previously made (or had made on their behalf) Archer MSA contributions and employees who are employed by a participating employer.

Trustees of Archer MSAs are generally required to make reports to the Treasury by August 1 regarding Archer MSAs established by July 1 of that year. If the threshold level is reached in a year, the Secretary is required to make and publish such determination by October 1 of such year.

Health savings accounts

Health savings accounts ("HSAs") were enacted by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003. Like Archer MSAs, an HSA is a tax-exempt trust or custodial account to which tax-deductible contributions may be made by individuals with a high deductible health plan. HSAs provide tax benefits similar to, but more favorable than, those provided by Archer MSAs. HSAs were established on a permanent basis.

HOUSE BILL

The House bill extends for one year the present-law Archer MSA provisions (through December 31, 2006).

The report required by Archer MSA trustees 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 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.

Effective date.—The provision is effective on the date of enactment.

SENATE AMENDMENT

No provision.

CONFERENCE AGREEMENT

The conference agreement does not include the House bill provision.

F. Fifteen-Year Straight-Line Cost Recovery for Qualified Leasehold Improvements and Qualified Restaurant Improvements

(Sec. 107 and sec. 108 of the House bill, sec. 117 of the Senate amendment, 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 prop-

erty is recovered using the straight-line method. Leasehold improvements placed in service in 2006 and later will be subject to the general rules described above.

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

Qualified restaurant property

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

HOUSE BILL

Under the House bill, the present-law provisions relating to qualified leasehold improvement property and qualified restaurant improvement property are extended for one year (through December 31, 2006).

Effective date.—The House bill applies to property placed in service after December 31, 2005.

SENATE AMENDMENT

Under the Senate amendment, the present-law provisions are extended for two years (through December 31, 2007).

Effective date.—The Senate amendment applies to property placed in service after December 31, 2005.

CONFERENCE AGREEMENT

The conference agreement does not include the House bill provision or the Senate amendment provision.

G. Taxable Income Limit on Percentage Depletion for Oil and Natural Gas Produced From Marginal Properties

(Sec. 109 of the House bill and sec. 613A(c)(6)(H) 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).

HOUSE BILL

The provision extends for one year the present-law taxable income limitation suspension provision for marginal production (through taxable years beginning on or before December 31, 2006).

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

SENATE AMENDMENT

No provision.

CONFERENCE AGREEMENT

The conference agreement does not include the House bill provision.

H. Tax Incentives for Investment in the District of Columbia

(Sec. 110 of the House bill, sec. 114 of the Senate amendment 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."[3]

An employer's deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.[4] 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

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

[4] Sec. 280C(a).

credit under section 51A.[5] 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.[6] The wage credit may be used to offset up to 25 percent of alternative minimum tax liability.[7]

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.[8] The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified zone property placed in service during the year by the taxpayer exceeds $200,000 ($400,000 for taxable years beginning after 2002 and before 2008). The term "qualified zone property" is defined as depreciable tangible property (including buildings), provided that (1) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (2) the original use of the property in the D.C. Zone commences with the taxpayer, and (3) substantially all of the use of the property is in the D.C. Zone in the active conduct of a trade or business by the taxpayer.[9] 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.[10] Such bonds are subject to the District of Columbia's annual private activity bond volume limitation. Generally, qualified enterprise zone facility bonds for the District of Columbia are bonds 95 percent or more of the net proceeds of which are used to finance certain facilities within the D.C. Zone. The aggregate face amount of all outstanding qualified enterprise zone facility bonds per qualified D.C. Zone business may not exceed $15 million and may be issued only while the D.C. Zone designation is in effect.

Zero-percent capital gains

A zero-percent capital gains rate applies to capital gains from the sale of certain qualified D.C. Zone assets held for more than five years.[11] 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

[5] Secs. 1400H(a), 1396(c)(3)(A) and 51A(d)(2).
[6] Secs. 1400H(a), 1396(c)(3)(B) and 51A(d)(2).
[7] Sec. 38(c)(2).
[8] Sec. 1397A.
[9] Sec. 1397D.
[10] Sec. 1400A.
[11] Sec. 1400B.

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.[12] 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 is scheduled to expire for residences purchased after December 31, 2005.[13]

HOUSE BILL

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

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

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

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

Effective date.—The amendment generally is effective on January 1, 2006, except the provision relating to bonds is effective for obligations issued after the date of enactment.

SENATE AMENDMENT

The Senate amendment is the same as the House bill.

Effective date.—The provision is effective on the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the House bill provision or the Senate amendment provision.

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[12] 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).

[13] Sec. 1400C(i).

I. Possession Tax Credit With Respect to American Samoa

(Sec. 111 of the House bill and sec. 936 of the Code)

PRESENT LAW

In general

Certain domestic corporations with business operations in the U.S. possessions are eligible for the possession tax credit.[14] This credit offsets the U.S. tax imposed on certain income related to operations in the U.S. possessions.[15] For purposes of the section 936 credit, possessions include, among other places, American Samoa. Income eligible for the section 936 credit includes non-U.S. source 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 investments. 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. A domestic corporation that has elected the possession tax credit and that satisfies these two conditions for a taxable year generally is entitled to a credit against the U.S. tax attributable to the taxpayer's income that is eligible for the section 936 credit.

The possession tax credit applies 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.[16] 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

[14] Secs. 27(b), 936.

[15] 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.

[16] 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.

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 qualifying possession wage and fringe benefit expenses, (2) 15 percent of depreciation allowances with respect to short-life qualifying tangible property, plus 40 percent of depreciation allowances with respect to medium-life qualifying tangible property, plus 65 percent of depreciation allowances with respect to long-life tangible property, and (3) in certain cases, a portion of the taxpayer's possession income taxes.

Income-based limit

As an alternative to the economic activity-based limit, a taxpayer may elect to apply a limit equal to the applicable percentage of the credit that would otherwise be allowable with respect to possession business income; the applicable percentage currently is 40 percent.

Repeal and phase out

In 1996, the section 936 credit was repealed for new claimants for taxable years beginning after 1995 and was phased out for existing credit claimants over a period including taxable years beginning before 2006. The amount of the available credit during the phaseout period generally is reduced by special limitation rules. These phaseout 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. 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.

HOUSE BILL

The House bill extends for one year the present-law section 936 credit as applied to American Samoa; it thus allows existing credit claimants to claim the credit for income from activities in American Samoa in taxable years beginning on or before December 31, 2006.

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

SENATE AMENDMENT

No provision.

CONFERENCE AGREEMENT

The conference agreement does not include the House bill provision.

J. Parity in the Application of Certain Limits to Mental Health Benefits

(Sec. 112 of the House bill and sec. 9812 of the Code)

PRESENT LAW [17]

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

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

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

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

HOUSE BILL

The House bill extends for one year the present-law Code excise tax for failure to comply with the mental health parity requirements (through December 31, 2006).

Effective date.—The provision is effective on the date of enactment.

SENATE AMENDMENT

No provision.

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[17] This description of present law refers to the law in effect at the time the bill passed the House of Representatives, which was before the enactment of Pub. L. No. 109–151, which extended the mental health parity requirements of the Code, ERISA, and the PHSA through December 31, 2006.

CONFERENCE AGREEMENT

The conference agreement does not include the House bill provision.

K. RESEARCH CREDIT

(Sec. 113 of the House bill, sec. 108 of the Senate amendment, 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.[18] 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.[19]

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[18] Sec. 41.

[19] The research tax credit initially was enacted in the Economic Recovery Tax Act of 1981 as a credit equal to 25 percent of the excess of qualified research expenses incurred in the current taxable year over the average of qualified research expenses incurred in the prior three taxable years. The research tax credit was modified in the Tax Reform Act of 1986, which (1) extended the credit through December 31, 1988, (2) reduced the credit rate to 20 percent, (3) tightened the definition of qualified research expenses eligible for the credit, and (4) enacted the separate university basic credit.

The Technical and Miscellaneous Revenue Act of 1988 ("1988 Act") extended the research tax credit for one additional year, through December 31, 1989. The 1988 Act also reduced the deduction allowed under section 174 (or any other section) for qualified research expenses by an amount equal to 50 percent of the research tax credit determined for the year.

The Omnibus Budget Reconciliation Act of 1989 ("1989 Act") effectively extended the research credit for nine months (by prorating qualified expenses incurred before January 1, 1991). The 1989 Act also modified the method for calculating a taxpayer's base amount (i.e., by substituting the present-law method which uses a fixed-base percentage for the prior-law moving base which was calculated by reference to the taxpayer's average research expenses incurred in the preceding three taxable years). The 1989 Act further reduced the deduction allowed under section 174 (or any other section) for qualified research expenses by an amount equal to 100 percent of the research tax credit determined for the year.

Continued

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.[20]

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 re-

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The Omnibus Budget Reconciliation Act of 1990 extended the research tax credit through December 31, 1991 (and repealed the special rule to prorate qualified expenses incurred before January 1, 1991).

The Tax Extension Act of 1991 extended the research tax credit for six months (i.e., for qualified expenses incurred through June 30, 1992).

The Omnibus Budget Reconciliation Act of 1993 ("1993 Act") extended the research tax credit for three years—i.e., retroactively from July 1, 1992 through June 30, 1995. The 1993 Act also provided a special rule for start-up firms, so that the fixed-base ratio of such firms eventually will be computed by reference to their actual research experience.

Although the research tax credit expired during the period July 1, 1995, through June 30, 1996, the Small Business Job Protection Act of 1996 ("1996 Act") extended the credit for the period July 1, 1996, through May 31, 1997 (with a special 11-month extension for taxpayers that elect to be subject to the alternative incremental research credit regime). In addition, the 1996 Act expanded the definition of start-up firms under section 41(c)(3)(B)(i), enacted a special rule for certain research consortia payments under section 41(b)(3)(C), and provided that taxpayers may elect an alternative research credit regime (under which the taxpayer is assigned a three-tiered fixed-base percentage that is lower than the fixed-base percentage otherwise applicable and the credit rate likewise is reduced) for the taxpayer's first taxable year beginning after June 30, 1996, and before July 1, 1997.

The Taxpayer Relief Act of 1997 ("1997 Act") extended the research credit for 13 months—i.e, generally for the period June 1, 1997, through June 30, 1998. The 1997 Act also provided that taxpayers are permitted to elect the alternative incremental research credit regime for any taxable year beginning after June 30, 1996 (and such election will apply to that taxable year and all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury). The Tax and Trade Relief Extension Act of 1998 extended the research credit for 12 months, i.e., through June 30, 1999.

The Ticket to Work and Work Incentive Improvement Act of 1999 extended the research credit for five years, through June 30, 2004, increased the rates of credit under the alternative incremental research credit regime, and expanded the definition of research to include research undertaken in Puerto Rico and possessions of the United States.

The Working Families Tax Relief Act of 224 extended the research credit through December 31, 2005.

The Energy Tax Incentives Act of 2005 added the energy research credit.

[20] 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 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)).

lated 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.[21] If a taxpayer elected to be subject to this alternative regime, the taxpayer was assigned a three-tiered fixed-base percentage (that was lower than the fixed-base percentage otherwise applicable) and the credit rate likewise was reduced. Under the alternative incremental credit regime, a credit rate of 2.65 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equaled one percent of the taxpayer's average gross receipts for the four preceding years) but did not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of 1.5 percent but did not exceed a base amount computed by using a fixed-base percentage of two percent. A credit rate of 3.75 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of two percent. An election to be subject to this alternative incremental credit regime could be made for any taxable year beginning after June 30, 1996, and such an election applied to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury.

Eligible expenses

Qualified research expenses eligible for the research tax credit consisted of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).[22] Notwithstanding the limitation for contract research expenses, qualified research expenses included 100 percent of amounts paid or incurred by the taxpayer to an eli-

[21] Sec. 41(c)(4).

[22] Under a special rule enacted as part of the Small Business Job Protection Act of 1996, 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).

gible 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. 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.[23] 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)).

HOUSE BILL

The provision extends for one year and modifies the present-law research credit provision (for amounts paid or incurred through December 31, 2006).

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 per-

[23] 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).

cent (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 5 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 credit may not be made for any taxable year for which an election to use the alternative incremental credit is in effect. A special 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 the date of enactment of the provision. The transition rule only applies to the taxable year which includes the date of enactment.

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 creation of the alternative simplified credit are effective for taxable years ending after date of enactment.

SENATE AMENDMENT

The Senate amendment generally follows the House bill but provides for a two-year extension of the modified research credit. It also adds a provision that broadens the research credit as it applies to research consortia. Under the Senate amendment, a 20 percent credit would be available for a taxpayer's expenditures on research carried out by any research consortium, rather than being limited to research carried out by an energy research consortium.

Effective date.—The Senate amendment applies to amounts paid or incurred after December 31, 2005.

CONFERENCE AGREEMENT

The conference agreement does not include the House bill provision or the Senate amendment provision.

L. Qualified Zone Academy Bonds

(Sec. 114 of the House bill, sec. 110 of the Senate amendment 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 (sec. 103).

Qualified zone academy bonds

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

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

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

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

A school is a "qualified zone academy" if: (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in an empowerment zone or enterprise community

designated under the Code or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

Arbitrage restrictions on tax-exempt bonds

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

HOUSE BILL

The House bill extends for one year the present-law provision relating to qualified zone academy bonds (through December 31, 2006).

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

SENATE AMENDMENT

The Senate amendment extends for two years the present-law provision relating to qualified zone academy bonds (through December 31, 2007).

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

The provision imposes new spending requirements for qualified zone academy bonds. An issuer of qualified zone academy bonds must reasonably expect to and actually spend 95 percent or more of the proceeds of such bonds on qualified zone academy property within the five-year period that begins on the date of issuance. To the extent less than 95 percent of the proceeds are used to finance qualified zone academy property during the five-year spending period, bonds will continue to qualify as qualified zone academy bonds if unspent proceeds are used within 90 days from the end

of such five-year period to redeem any "nonqualified bonds." For these purposes, the amount of nonqualified bonds is to be determined in the same manner as Treasury regulations under section 142. In addition, the provision provides that the five-year spending period may be extended by the Secretary upon the issuer's request if reasonable cause for such extension is established.

Under the provision, qualified private business contributions must be in the form of cash or cash equivalents, rather than property or services as permitted under present law. The provision also requires an equal amount of principal is to be paid by the issuer during each calendar year that the issue is outstanding.

Under the provision, issuers of qualified zone academy bonds are required to report issuance to the IRS in a manner similar to that required for tax-exempt bonds.

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

CONFERENCE AGREEMENT

The conference agreement does not include the House bill provision or the Senate amendment provision.

M. Above-the-Line Deduction for Certain Expenses of Elementary and Secondary School Teachers

(Sec. 115 of the House bill, sec. 112 of the Senate amendment 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 $145,950 (for 2005). In addition, miscellaneous itemized deductions are not allowable under the alternative minimum tax.

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

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

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

HOUSE BILL

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

Effective date.—The provision is effective for expenses paid or incurred in taxable years beginning after December 31, 2005.

SENATE AMENDMENT

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.

CONFERENCE AGREEMENT

The conference agreement does not include the House bill provision or the Senate amendment provision.

N. Above-the-Line Deduction for Higher Education Expenses

(Sec. 116 of the House bill, sec. 103 of the Senate amendment 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 eligible for exclusion under section 222. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope credit or Lifetime Learning credit is elected for such taxable year.

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

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

HOUSE BILL

The provision extends the tuition deduction for one year, through December 31, 2006.

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

SENATE AMENDMENT

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

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

CONFERENCE AGREEMENT

The conference agreement does not include the House provision or the Senate amendment provision.

O. Deduction of State and Local General Sales Taxes

(Sec. 117 of the House bill, sec. 105 of the Senate amendment, 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 filing status, number of dependents, adjusted gross income and rates of State and local general sales taxation. Taxpayers who use the tables created by the Secretary may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats and other items specified by the Secretary. Sales taxes for items that may be added to the tables are not reflected in the tables themselves.

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

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

HOUSE BILL

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

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

SENATE AMENDMENT

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.

CONFERENCE AGREEMENT

The conference agreement does not include the House bill provision or the Senate amendment provision.

P. Extension and Expansion to Petroleum Products of Expensing for Environmental Remediation Costs

(Sec. 201 of the House bill, sec. 113 of the Senate amendment, 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.[24] 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.[25] 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.[26] and section 263A, are treated as qualified environmental remediation expenditures.

A "qualified contaminated site" (a so-called "brownfield") generally is any property that is held for use in a trade or business, for the production of income, or as inventory and is certified by the appropriate State environmental agency to be an area at or on which there has been a release (or threat of release) or disposal of a hazardous substance. Both urban and rural property may qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA")[27] cannot qualify as targeted areas. Hazardous substances generally are defined by reference to

[24] Sec. 162.
[25] Sec. 198.
[26] 418 U.S. 1 (1974).
[27] Pub. L. No. 96–510 (1980).

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).[28]

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)).

HOUSE BILL

The House bill 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.[29]

Effective date.—The provision applies to expenditures paid or incurred after December 31, 2005.

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[28] 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."

[29] The present law exceptions for sites on the national priorities list under CERCLA, and for substances with respect to which a removal or remediation is not permitted under section 104 of CERCLA by reason of subsection (a)(3) thereof, would continue to apply to all hazardous substances (including petroleum products).

SENATE AMENDMENT

The Senate amendment modifies the House bill to provide for only a one-year extension of the present-law provisions relating to environmental remediation expenditures (through December 31, 2006). The Senate amendment follows the House bill in expanding the definition of hazardous substances to include petroleum products.

Effective date.—The provision applies to expenditures paid or incurred after December 31, 2005.

CONFERENCE AGREEMENT

The conference agreement does not include the House bill provision or the Senate amendment provision.

Q. Controlled Foreign Corporations

1. Subpart F exception for active financing (Sec. 202(a) of the House bill and secs. 953 and 954 of the Code)

PRESENT LAW

Under the subpart F rules, 10-percent U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, insurance income and foreign base company income. Foreign base company income includes, among other things, foreign personal holding company income and foreign base company services income (i.e., income derived from services performed for or on behalf of a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from certain foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; (7) payments in lieu of dividends; and (8) amounts received under personal service contracts.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the

CFC's country of organization is taxable as subpart F insurance income.[30]

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income").[31]

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of insurance, in addition to a temporary exception from foreign personal holding company income for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, certain temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met.

In the case of a life insurance or annuity contract, reserves for such contracts are determined as follows for purposes of these provisions. The reserves equal the greater of: (1) the net surrender value of the contract (as defined in section 807(e)(1)(A)), including in the case of pension plan contracts; or (2) the amount determined by applying the tax reserve method that would apply if the qualifying life insurance company were subject to tax under Subchapter L of the Code, with the following modifications. First, there is sub-

[30] Prop. Treas. Reg. sec. 1.953–1(a).

[31] Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998. Those exceptions were modified and extended for one year, applicable only for taxable years beginning in 1999. The Tax Relief Extension Act of 1999 (Pub. L. No. 106–170) clarified and extended the temporary exceptions for two years, applicable only for taxable years beginning after 1999 and before 2002. The Job Creation and Worker Assistance Act of 2002 (Pub. L. No. 107–147) modified and extended the temporary exceptions for five years, for taxable years beginning after 2001 and before 2007.

stituted for the applicable Federal interest rate an interest rate determined for the functional currency of the qualifying insurance company's home country, calculated (except as provided by the Treasury Secretary in order to address insufficient data and similar problems) in the same manner as the mid-term applicable Federal interest rate (within the meaning of section 1274(d)). Second, there is substituted for the prevailing State assumed rate the highest assumed interest rate permitted to be used for purposes of determining statement reserves in the foreign country for the contract. Third, in lieu of U.S. mortality and morbidity tables, mortality and morbidity tables are applied that reasonably reflect the current mortality and morbidity risks in the foreign country. Fourth, the Treasury Secretary may provide that the interest rate and mortality and morbidity tables of a qualifying insurance company may be used for one or more of its branches when appropriate. In no event may the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe, equalization, or deficiency reserve or any similar reserve.

Present law permits a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes. In seeking a ruling, the taxpayer is required to provide the IRS with necessary and appropriate information as to the method, interest rate, mortality and morbidity assumptions and other assumptions under the foreign reserve rules so that a comparison can be made to the reserve amount determined by applying the tax reserve method that would apply if the qualifying insurance company were subject to tax under Subchapter L of the Code (with the modifications provided under present law for purposes of these exceptions). The IRS also may issue published guidance indicating its approval. Present law continues to apply with respect to reserves for any life insurance or annuity contract for which the IRS has not approved the use of the foreign statement reserve. An IRS ruling request under this provision is subject to the present-law provisions relating to IRS user fees.

HOUSE BILL

The House bill extends for two years (for taxable years beginning before 2009) the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

Effective date.—The provision is effective for taxable years of foreign corporations beginning after December 31, 2006, and before

January 1, 2009, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

SENATE AMENDMENT

No provision.

CONFERENCE AGREEMENT

The conference agreement includes the House bill provision.

2. Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company income rules (sec. 202(b) of the House bill and sec. 954(c) of the Code)

PRESENT LAW

In general, the rules of subpart F (secs. 951–964) require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation ("CFC") to include certain income of the CFC (referred to as "subpart F income") on a current basis for U.S. tax purposes, regardless of whether the income is distributed to the shareholders.

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents, and royalties, among other types of income. However, foreign personal holding company income does not include dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized, or rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor.

HOUSE BILL

Under the House bill, for taxable years beginning after 2005 and before 2009, dividends, interest,[32] rents, and royalties received by one CFC from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to non-subpart-F income of the payor. For this purpose, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC's stock (by vote or value) constitutes control for these purposes. The bill provides that the Secretary shall prescribe such regulations as are appropriate to prevent the abuse of the purposes of this provision.

The provision in the House bill is effective for taxable years of foreign corporations beginning after December 31, 2005, but before

[32] Interest for this purpose includes factoring income which is treated as equivalent to interest under sec. 954(c)(1)(E).

January 1, 2009, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

SENATE AMENDMENT

No provision.

CONFERENCE AGREEMENT

The conference agreement includes the House bill provision.

R. REDUCED RATES FOR CAPITAL GAINS AND DIVIDENDS OF INDIVIDUALS

(Sec. 203 of the House bill and sec. 1(h) of the Code)

PRESENT LAW

Capital gains

In general

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

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

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

Tax rates before 2009

Under present law, for taxable years beginning before January 1, 2009, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. Any adjusted net capital gain which

otherwise would be taxed at a 10- or 15-percent rate is taxed at a 5-percent rate (zero for taxable years beginning after 2007). These rates apply for purposes of both the regular tax and the alternative minimum tax.

Under present law, the "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d).

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

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

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

Tax rates after 2008

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

In addition, any gain from the sale or exchange of property held more than five years that would otherwise have been taxed at the 10-percent rate is taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, that would otherwise have been taxed at a 20-percent rate is taxed at an 18-percent rate.

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

Dividends

In general

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

Tax rates before 2009

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

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

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

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

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

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

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

The amount of dividends qualifying for reduced rates that may be paid by a regulated investment company ("RIC") for any taxable year in which the qualified dividend income received by the RIC is less than 95 percent of its gross income (as specially computed) may not exceed the sum of (i) the qualified dividend income of the

RIC for the taxable year and (ii) the amount of earnings and profits accumulated in a non-RIC taxable year that were distributed by the RIC during the taxable year.

The amount of dividends qualifying for reduced rates that may be paid by a real estate investment trust ("REIT") for any taxable year may not exceed the sum of (i) the qualified dividend income of the REIT for the taxable year, (ii) an amount equal to the excess of the income subject to the taxes imposed by section 857(b)(1) and the regulations prescribed under section 337(d) for the preceding taxable year over the amount of these taxes for the preceding taxable year, and (iii) the amount of earnings and profits accumulated in a non-REIT taxable year that were distributed by the REIT during the taxable year.

The reduced rates do not apply to dividends received from an organization that was exempt from tax under section 501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or the preceding taxable year; dividends received from a mutual savings bank that received a deduction under section 591; or deductible dividends paid on employer securities.[33]

Tax rates after 2008

For taxable years beginning after 2008, dividends received by an individual are taxed at ordinary income tax rates.

HOUSE BILL

The House bill extends for two years the present-law provisions relating to lower capital gain and dividend tax rates (through taxable years beginning on or before December 31, 2010).

Effective date.—The provision applies to taxable years beginning after December 31, 2008.

SENATE AMENDMENT

No provision.

CONFERENCE AGREEMENT

The conference agreement includes the House bill provision.

S. Credit for Elective Deferrals and IRA Contributions (the "Saver's Credit")

(Sec. 204 of the House bill, sec. 102 of the Senate amendment, and sec. 25B of the Code)

PRESENT LAW

Present law provides a temporary nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions, referred to as the "saver's credit." The maximum annual contribution eligible for the credit is $2,000. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. Taxpayers filing joint

[33] In addition, for taxable years beginning before 2009, amounts treated as ordinary income on the disposition of certain preferred stock (sec. 306) are treated as dividends for purposes of applying the reduced rates; the tax rate for the accumulated earnings tax (sec. 531) and the personal holding company tax (sec. 541) is reduced to 15 percent; and the collapsible corporation rules (sec. 341) are repealed.

returns with AGI of $50,000 or less, head of household returns of $37,500 or less, and single returns of $25,000 or less are eligible for the credit. The AGI limits applicable to single taxpayers apply to married taxpayers filing separate returns. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return.

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

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

The credit rates based on AGI are provided below.

TABLE 1.—CREDIT RATES FOR SAVER'S CREDIT

Joint filers	Heads of households	All other filers	Credit rate (percent)
$0–$30,000	$0–$22,500	$0–$15,000	50
30,001–32,500	22,501–24,375	15,001–16,250	20
32,501–50,000	24,376–37,500	16,251–25,000	10
Over $50,000	Over $37,500	Over $25,000	0

The credit does not apply to taxable years beginning after December 31, 2006.[34]

HOUSE BILL

The House bill extends the saver's credit for two years, through December 31, 2008.

Effective date.—The provision is effective on the date of enactment.

SENATE AMENDMENT

The Senate amendment extends the saver's credit for three years, through December 31, 2009.

Effective date.—The provision is effective on the date of enactment.

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

CONFERENCE AGREEMENT

The conference agreement does not include the House bill provision or the Senate amendment provision.

T. Extension of Increased Expensing for Small Business

(Sec. 205 of the House bill, sec. 101 of the Senate amendment, and sec. 179 of the Code)

PRESENT LAW

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs. Present law provides that the maximum amount a taxpayer may expense, for taxable years beginning in 2003 through 2007, is $100,000 of the cost of qualifying property placed in service for the taxable year.[35] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2008 is treated as qualifying property. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. The $100,000 and $400,000 amounts are indexed for inflation for taxable years beginning after 2003 and before 2008.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.[36]

For taxable years beginning in 2008 and thereafter (or before 2003), the following rules apply. A taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not in-

[35] Additional section 179 incentives are provided with respect to a qualified property used by a business in the New York Liberty Zone (sec. 1400L(f)), an empowerment zone (sec. 1397A), or a renewal community (sec. 1400J).

[36] Sec. 179(c)(1). Under Treas. Reg. sec. 179–5, applicable to property placed in service in taxable years beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9209, July 12, 2005.

cluding off-the-shelf computer software). An expensing election may be revoked only with consent of the Commissioner.[37]

HOUSE BILL

The provision extends for two years the increased amount that a taxpayer may deduct and the other section 179 rules applicable in taxable years beginning before 2008. Thus, under the provision, these present-law rules continue in effect for taxable years beginning after 2007 and before 2010.

Effective date.—The provision is effective for taxable years beginning after 2007 and before 2010.

SENATE AMENDMENT

The Senate amendment provision is the same as the House bill.

CONFERENCE AGREEMENT

The conference agreement includes the provision in the House bill and the Senate amendment.

U. Extend and Increase Alternative Minimum Tax Exemption Amount for Individuals

(Sec. 106 of the Senate amendment and sec. 55 of the Code)

PRESENT LAW

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

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

[37] Sec. 179(c)(2).

HOUSE BILL

No provision.

SENATE AMENDMENT

Under the Senate amendment, for taxable years beginning in 2006, the exemption amounts are increased to: (1) $62,550 in the case of married individuals filing a joint return and surviving spouses; (2) $42,500 in the case of unmarried individuals other than surviving spouses; and (3) $31,275 in the case of married individuals filing a separate return.

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

CONFERENCE AGREEMENT

The conference agreement includes the provision in the Senate amendment.

V. Extension and Modification of the New Markets Tax Credit

(Sec. 204 of the Senate amendment 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").[38] The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years. The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available for a taxable year to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity ceases to be a qualified CDE, the proceeds of the investment cease to be used as required, or the equity investment is redeemed.

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

[38] Section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, P.L. No. 106–554 (December 21, 2000).

such investment was a qualified equity investment in the hands of the prior holder. Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.

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

The Secretary has the authority to designate "targeted populations" as low-income communities for purposes of the new markets tax credit. For this purpose, a "targeted population" is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4702(20)) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who (A) are low-income persons; or (B) otherwise lack adequate access to loans or equity investments. Under such Act, "low-income" means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income or 80 percent of the statewide non-metropolitan area median family income.[39] 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 per-

[39] 12 U.S.C. 4702(17) (defines "low-income" for purposes of 12 U.S.C. 4702(20)).

formed 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.

HOUSE BILL

No provision.

SENATE AMENDMENT

The provision extends through 2008 the $3.5 billion maximum annual amount of qualified equity investments. 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.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

W. PHASEDOWN OF CREDIT FOR ELECTRIC VEHICLES

(Sec. 118 of the Senate amendment and sec. 30 of the Code)

PRESENT LAW

A 10-percent tax credit is provided for the cost of a qualified electric vehicle, up to a maximum credit of $4,000. A qualified electric vehicle generally is a motor vehicle that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current. The full amount of the credit is available for purchases prior to 2006. The credit is reduced to 25 percent of the otherwise allowable amount for purchases in 2006, and is unavailable for purchases after December 31, 2006.

HOUSE BILL

No provision.

SENATE AMENDMENT

Under the Senate amendment, the full amount of the credit for qualified electric vehicles is available for purchases prior to 2006. As under present law, the credit is unavailable for purchases after December 31, 2006.

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

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

X. Application of EGTRRA Sunset to Title II of the Senate Amendment

(Sec. 231 of the Senate amendment)

PRESENT LAW

Reconciliation is a procedure under the Congressional Budget Act of 1974 (the "Budget Act") by which Congress implements spending and tax policies contained in a budget resolution. The Budget Act contains numerous rules enforcing the scope of items permitted to be considered under the budget reconciliation process. One such rule, the so-called "Byrd rule," was incorporated into the Budget Act in 1990. The Byrd rule, named after its principal sponsor, Senator Robert C. Byrd, is contained in section 313 of the Budget Act. The Byrd rule generally permits members to raise a point of order against extraneous provisions (those which are unrelated to the goals of the reconciliation process) from either a reconciliation bill or a conference report on such bill.

Under the Byrd rule, a provision is considered to be extraneous if it falls under one or more of the following six definitions:

1. It does not produce a change in outlays or revenues;
2. It produces an outlay increase or revenue decrease when the instructed committee is not in compliance with its instructions;
3. It is outside of the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure;
4. It produces a change in outlays or revenues which is merely incidental to the nonbudgetary components of the provision;
5. It would increase the deficit for a fiscal year beyond those covered by the reconciliation measure; and
6. It recommends changes in Social Security.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) contains sunset provisions to ensure compliance with the Budget Act. Under title IX of EGTRRA, the provisions of, and amendments made by that Act that are in effect on September 30, 2011, shall cease to apply as of the close of September 30, 2011, except that all provisions of, and amendments made by, the Act generally do not apply for taxable, plan or limitation years beginning after December 31, 2010. With respect to the estate, gift, and generation-skipping provisions of the Act, the provisions do not apply to estates of decedents dying, gifts made, or generation-skipping transfers, after December 31, 2010. The Code and the Employee Retirement Income Security Act of 1974 are applied to such years, estates, gifts and transfers after December 31, 2010, as if the provisions of and amendments made by the Act had never been enacted.

HOUSE BILL

No provision.

SENATE AMENDMENT

Sunset of provisions

To ensure compliance with the Budget Act, the Senate amendment provides that all provisions of, and amendments made by title II of the Senate amendment shall be subject to the sunset provisions of EGTRRA to the same extent and in the same manner as the provision of such Act to which the Senate amendment provision relates.

Effective date.—The provision is effective on the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

TITLE II—OTHER PROVISONS

A. Taxation of Certain Settlement Funds

(Sec. 301 of the House bill and sec. 468B of the Code)

PRESENT LAW

Present law provides that if a taxpayer makes a payment to a designated settlement fund pursuant to a court order, the deduction timing rules that require economic performance generally are deemed to be met as the payments are made by the taxpayer to the fund. A designated settlement fund means a fund which: is established pursuant to a court order; extinguishes completely the taxpayer's tort liability arising out of personal injury, death or property damage; is administered by persons a majority of whom are independent of the taxpayer; and under the terms of the fund the taxpayer (or any related person) may not hold any beneficial interest in the income or corpus of the fund.

Generally, a designated or qualified settlement fund is taxed as a separate entity at the maximum trust rate on its modified income. Modified income is generally gross income less deductions for administrative costs and other incidental expenses incurred in connection with the operation of the settlement fund.

The cleanup of hazardous waste sites is sometimes funded by environmental "settlement funds" or escrow accounts. These escrow accounts are established in consent decrees between the Environmental Protection Agency ("EPA") and the settling parties under the jurisdiction of a Federal district court. The EPA uses these accounts to resolve claims against private parties under Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA").

Present law provides that nothing in any provision of law is to be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax.

HOUSE BILL

The provision provides that certain settlement funds established in consent decrees for the sole purpose of resolving claims

under CERCLA are to be treated as beneficially owned by the United States government and therefore not subject to Federal income tax.

To qualify the settlement fund must be: (1) established pursuant to a consent decree entered by a judge of a United States District Court; (2) created for the receipt of settlement payments for the sole purpose of resolving claims under CERCLA; (3) controlled (in terms of expenditures of contributions and earnings thereon) by the government or an agency or instrumentality thereof; and (4) upon termination, any remaining funds will be disbursed to such government entity and used in accordance with applicable law. For purposes of the provision, a government entity means the United States, any State of political subdivision thereof, the District of Columbia, any possession of the United States, and any agency or instrumentality of the foregoing.

The provision does not apply to accounts or funds established after December 31, 2010.

Effective date.—The provision is effective for accounts and funds established after the date of enactment.

SENATE AMENDMENT

No provision.

CONFERENCE AGREEMENT

The conference agreement includes the House bill provision.

B. Modifications to Rules Relating to Taxation of Distributions of Stock and Securities of a Controlled Corporation

(Sec. 302 of the House bill, sec. 467 of the Senate amendment 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").[40] For this purpose, a corporation is engaged in the active conduct of a trade or business only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) the corporation is not directly engaged in an active business, but substantially all its assets consist of stock and securities of one or more corporations that it controls that are engaged in the active conduct of a trade or business.[41]

In determining whether a corporation is directly engaged in an active trade or business that satisfies the requirement, old IRS guidelines for advance ruling purposes required that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least five percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[42] More recently, the IRS has suspended this specific rule in connection with its general administrative practice of moving IRS resources away from advance rulings on factual aspects of section 355 transactions in general.[43]

If the distributing or controlled corporation is not directly engaged in an active trade or business, then the IRS takes the position that the "substantially all" test as applied to that corporation requires that at least 90 percent of the fair market value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business.[44]

In determining whether assets are part of a five-year qualifying active business, assets acquired more recently than five years prior to the distribution, in a taxable transaction, are permitted to qualify as five-year "active business" assets if they are considered to have been acquired as part of an expansion of an existing business that does so qualify.[45]

When a corporation holds an interest in a partnership, IRS revenue rulings have allowed an active business of the partnership to count as an active business of a corporate partner in certain circumstances. One such case involved a situation in which the corporation owned at least 20 percent of the partnership, was actively engaged in management of the partnership, and the partnership itself had an active business.[46]

In addition to its active business requirements, section 355 does not apply to any transaction that is a "device" for the distribution of earnings and profits to a shareholder without the payment of tax on a dividend. A transaction is ordinarily not considered a "device" to avoid dividend tax if the distribution would have been treated by the shareholder as a redemption that was a sale or ex-

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[40] Section 355(b).

[41] Section 355(b)(2)(A). The IRS takes the position that the statutory test requires that at least 90 percent of the fair market value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business. Rev. Proc. 96–30, sec. 4.03(5), 1996–1 C.B. 696; Rev. Proc. 77–37, sec. 3.04, 1977–2 C.B. 568.

[42] Rev. Proc. 2003–3, sec. 4.01(30), 2003–1 I.R.B. 113.

[43] Rev. Proc. 2003–48, 2003–29 I.R.B. 86.

[44] 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.

[45] Treas. Reg. sec. 1.355–3(b)(ii).

[46] Rev. Rul. 92–17, 1002–1 C.B. 142; see also, Rev. Rul. 2002–49, 2002–2 C.B. 50.

change of its stock, rather than as a dividend, if section 355 had not applied.[47]

HOUSE BILL

Under the House bill provision, the active business test is 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).

Effective date.—The provision applies to distributions after the date of enactment and 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 and before December 31, 2010.[48]

SENATE AMENDMENT

The Senate amendment provision is the same as the House bill with respect to the House bill provision described above, except for the date on which that provision sunsets.[49]

In addition, the Senate amendment contains another provision that denies section 355 treatment if either the distributing or distributed corporation is a disqualified investment corporation immediately after the transaction (including any series of related transactions) and any person that did not hold 50 percent or more of the voting power or value of stock of such distributing or controlled corporation immediately before the transaction does hold such a 50 percent or greater interest immediately after such transaction. The attribution rules of section 318 apply for purposes of this determination.

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[47] Treas. Reg. sec. 1.355–2(d)(5)(iv).

[48] 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 present 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 occurs after the date of enactment and before January 1, 2010, and that would satisfy the requirements of new section 355(b)(2)(A).

[49] See "Effective date" for the Senate Amendment, infra.

A disqualified investment corporation is any distributing or controlled corporation if the fair market value of the investment assets of the corporation is 75 percent or more of the fair market value of all assets of the corporation. Except as otherwise provided, the term "investment assets" for this purpose means (i) cash, (ii) any stock or securities in a corporation, (iii) any interest in a partnership, (iv) any debt instrument or other evidence of indebtedness; (v) any option, forward or futures contract, notional principal contract, or derivative; (vi) foreign currency, or (vii) any similar asset.

The term "investment assets" does not include any asset which is held for use in the active and regular conduct of (i) a lending or finance business (as defined in section 954(h)(4)); (ii) a banking business through a bank (as defined in section 581), a domestic building and loan association (within the meaning of section 7701(a)(19), or any similar institution specified by the Secretary; or (iii) an insurance business if the conduct of the business is licensed, authorized, or regulated by an applicable insurance regulatory body. These exceptions only apply with respect to any business if substantially all the income of the business is derived from persons who are not related (within the meaning of section 267(b) or 707(b)(1) to the person conducting the business.

The term "investment assets" also does not include any security (as defined in section 475(c)(2)) which is held by a dealer in securities and to which section 475(a) applies.

The term "investment assets" also does not include any stock or securities in, or any debt instrument, evidence of indebtedness, option, forward or futures contract, notional principal contract, or derivative issued by, a corporation which is a 25-percent controlled entity with respect to the distributing or controlled corporation. Instead, the distributing or controlled corporation is treated as owning its ratable share of the assets of any 25-percent controlled entity.

The term 25-percent controlled entity means any corporation with respect to which the corporation in question (distributing or controlled) owns directly or indirectly stock possessing at least 25 percent of voting power and value, excluding stock that is not entitled to vote, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and is not convertible into another class of stock.

The term "investment assets" also does not include any interest in a partnership, or any debt instrument or other evidence of indebtedness issued by the partnership, if one or more trades or businesses of the partnership are, (or without regard to the 5-year requirement of section 355(b)(2)(B), would be) taken into account by the distributing or controlled corporation, as the case may be, in determining whether the active business test of section 355 is met by such corporation.

The Treasury department shall provide regulations as may be necessary to carry out, or prevent the avoidance of, the purposes of the provision, including regulations in cases involving related persons, intermediaries, pass-through entities, or other arrangements; and the treatment of assets unrelated to the trade or busi-

ness of a corporation as investment assets if, prior to the distribution, investment assets were used to acquire such assets. Regulations may also in appropriate cases exclude from the application of the provision a distribution which does not have the character of a redemption and which would be treated as a sale or exchange under section 302, and may modify the application of the attribution rules.

Effective date.—The effective date of the first provision of the Senate amendment generally is the same as the effective date of the identical provision of the House bill, except that the Senate amendment provision sunsets for distributions (and for acquisitions, dispositions, or other restructurings as relating to continuing qualification of pre-effective date distributions) after December 31, 2009, rather than for distributions (and for acquisitions, dispositions, or other restructurings as relating to continuing qualification of pre-effective date distributions) on or after December 31, 2010.

The second provision of the Senate amendment is effective for distributions after the date of enactment, except in transactions which are (i) made pursuant to an agreement which was binding on such date of enactment and at all times thereafter; (ii) described in a ruling request submitted to the Internal Revenue Service on or before such date, or (iii) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission.

CONFERENCE AGREEMENT

The conference agreement includes the House bill and the Senate amendment with modifications.

With respect to the provision that applies the active business test by reference to the relevant affiliated group, the conference agreement provision is the same as the House bill and the Senate amendment except for the date on which the conference agreement provision sunsets.[50]

With respect to the provision that affects transactions involving disqualified investment corporations, the conference agreement reduces the percentage of investment assets of a corporation that will cause such corporation to be a disqualified investment corporation, from 75 percent (three-quarters) to two-thirds of the fair market value of the corporation's assets, for distributions occurring after one year after the date of enactment.

The conference agreement also reduces from 25 percent to 20 percent the percentage stock ownership in a corporation that will cause such ownership to be disregarded as an investment asset itself, instead requiring "look-through" to the ratable share of the underlying assets of such corporation attributable to such stock ownership.

The conferees wish to clarify that the disqualified investment corporation provision applies when a person directly or indirectly holds 50 percent of either the vote or the value of a company immediately following a distribution, and such person did not hold such 50 percent interest directly or indirectly prior to the distribution. As one example, the provision applies if a person that held 50 per-

[50] See "Effective date" of the conference agreement provision, infra.

cent or more of the vote, but not of the value, of a distributing corporation immediately prior to a transaction in which a controlled corporation that was 100 percent owned by that distributing corporation is distributed, directly or indirectly holds 50 percent of the value of either the distributing or controlled corporation immediately following such transaction.

The conferees further wish to clarify that the enumeration in subsection 355(g)(5)(A) through (C) of specific situations that Treasury regulations may address is not intended to restrict or limit any other situations that Treasury may address under the general authority of new section 355(g)(5) to carry out, or prevent the avoidance of, the purposes of the disqualified investment corporation provision.

Effective date.—The starting effective date of the provision that applies the active business test by reference to the relevant affiliated group is the same as that of the House bill and the Senate amendment provisions. The conference agreement changes the date on which the provision sunsets so that the provision does not apply for distributions (or for acquisitions, dispositions, or other restructurings as relating to continuing qualification of pre-effective date distributions) occurring after December 31, 2010.

The effective date of the provision that affects transactions involving disqualified investment corporations is the same as that of the Senate amendment provision, except for the conference agreement reduction in the amount of investment assets of a corporation that will cause it to be a disqualified investment corporation, from three-quarters to two-thirds of the fair market value of all assets of the corporation. The two-thirds test applies for distributions occurring after one year after the date of enactment.

C. Qualified Veteran's Mortgage Bonds

(Sec. 303 of the House 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 veterans' mortgage bonds are private activity bonds the proceeds of which are used to make mortgage loans to certain veterans. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984. Qualified veterans' mortgage bonds are not subject to the State volume limitations generally applicable to private activity bonds. Instead, annual issuance in each State is subject to a State volume limitation based on the volume of such bonds issued by the State before June 22, 1984. The five States eligible to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin. Loans fi-

nanced with qualified veterans' mortgage bonds can be made only with respect to principal residences and can not be made to acquire or replace existing mortgages. Mortgage loans made with the proceeds of these bonds can be made only to veterans who served on active duty before 1977 and who applied for the financing before the date 30 years after the last date on which such veteran left active service (the "eligibility period").

Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers and purchase price limitations for the home financed with bond proceeds. In addition, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement).

HOUSE BILL

The House bill repeals the requirement that veterans receiving loans financed with qualified veterans' mortgage bonds must have served before 1977. It also reduces the eligibility period to 25 years (rather than 30 years) following release from the military service. The bill provides new State volume limits for these bonds for the five eligible States. In 2010, the new annual limit on the total volume of veterans' bonds is $25 million for Alaska, $66.25 million for California, $25 million for Oregon, $53.75 million for Texas, and $25 million for Wisconsin. These volume limits are phased-in over the four-year period immediately preceding 2010 by allowing the applicable percentage of the 2010 volume limits. The following table provides those percentages.

Calendar Year:	*Applicable Percentage is:*
2006	20
2007	40
2008	60
2009	80

The volume limits are zero for 2011 and each year thereafter. Unused allocation cannot be carried forward to subsequent years.

Effective date.—The provision generally applies to bonds issued after December 31, 2005. The provision expanding the definition of eligible veterans applies to financing provided after date of enactment.

SENATE AMENDMENT

No provision.

CONFERENCE AGREEMENT

The conference agreement includes the House bill with the following modifications. The conference agreement does not amend present law as it relates to qualified veterans' mortgage bonds issued by the States of California and Texas. In the case of qualified veterans' mortgage bonds issued by the States of Alaska, Oregon, and Wisconsin, (1) the requirement that veterans must have served before 1977 is repealed and (2) the eligibility period for ap-

plying for a loan following release from the military service is reduced from 30 years to 25 years.

In addition, the annual issuance of qualified veterans' mortgage bonds in the States of Alaska, Oregon and Wisconsin is subject to new State volume limitations which are phased in between the years 2006 and 2010. The State volume limit in these States for any calendar year after 2010 is zero.

Effective date.—The provision expanding the definition of eligible veterans applies to bonds issued on or after date of enactment. The provision amending State volume limitations applies to allocations of volume limitation made after April 5, 2006.

D. Capital Gains Treatment for Certain Self-Created Musical Works

(Sec. 304 of the House 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. Another exclusion from capital asset status applies to copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property held by a taxpayer whose personal efforts created the property (or held by a taxpayer whose basis in the property is determined by reference to the basis of the taxpayer whose personal efforts created the property). Consequently, when a taxpayer that owns copyrights in, for example, books, songs, or paintings that the taxpayer created (or when a taxpayer to which the copyrights have been transferred by the works' creator in a substituted basis transaction) sells the copyrights, gain from the sale is treated as ordinary income, not capital gain.

Charitable contributions

A taxpayer generally is allowed a deduction for the fair market value of property contributed to a charity. If a taxpayer makes a contribution of property that would have generated ordinary income (or short-term capital gain), the taxpayer's charitable contribution deduction generally is limited to the property's adjusted basis.

HOUSE BILL

The House bill provides that at the election of a taxpayer, the sale or exchange before January 1, 2011 of musical compositions or copyrights in musical works created by the taxpayer's personal ef-

forts (or having a basis determined by reference to the basis in the hands of the taxpayer whose personal efforts created the compositions or copyrights) is treated as the sale or exchange of a capital asset. The House bill provision does not change the present law limitation on a taxpayer's charitable deduction for the contribution of those compositions or copyrights.

Effective date.—The provision is effective for sales or exchanges in taxable years beginning after the date of enactment.

SENATE AMENDMENT

No provision.

CONFERENCE AGREEMENT

The conference agreement includes the House bill provision.

E. Decrease Minimum Vessel Tonnage Limit to 6,000 Deadweight Tons

(Sec. 305 of the House 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")[51] generally allows corporations that are qualifying vessel operators[52] to elect a "tonnage tax" in lieu of the corporate income tax on taxable income from certain shipping activities. Accordingly, an electing corporation's gross income does not include its income from qualifying shipping activities (and items of loss, deduction, or credit are disallowed with respect to such excluded income), and electing corporations are only subject to tax on these activities at the maximum corporate income tax rate on their notional shipping income, which is based on the net tonnage of the corporation's qualifying vessels.[53] No deductions are allowed against the notional shipping income of an electing corporation, and no credit is allowed against the notional tax imposed under the tonnage tax regime. In addition, special deferral rules apply to the gain on the sale of a qualifying vessel, if such vessel is replaced during a limited replacement period.

Generally, a "qualifying vessel" is defined as a self-propelled (or a combination of self-propelled and non-self-propelled) U.S.-flag vessel of not less than 10,000 deadweight tons[54] that is used exclusively in the U.S. foreign trade.

HOUSE BILL

The House bill expands the definition of "qualifying vessel" to include self-propelled (or a combination of self-propelled and non-self-propelled) U.S. flag vessels of not less than 6,000 deadweight tons used exclusively in the United States foreign trade. The modified definition applies for taxable years beginning after December 31, 2005 and ending before January 1, 2011.

Effective date.—The provision applies to taxable years beginning after December 31, 2005 and ending before January 1, 2011.

SENATE AMENDMENT

No provision.

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[51] 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).

[52] 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.

[53] 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.

[54] 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.

CONFERENCE AGREEMENT

The conference agreement includes the provision in the House bill.

F. MODIFICATION OF SPECIAL ARBITRAGE RULE FOR CERTAIN FUNDS

(Sec. 306 of the House bill and sec. 307 of the Senate amendment)

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.[55]

HOUSE BILL

The provision codifies and extends the IRS agreement until August 31, 2009. The 1984 exception is conformed to the State constitutional amendments to permit its continued applicability to

[55] H.R. 2661.

bonds of the two university systems. The limitation on the aggregate amount of bonds which may benefit from the exception is not modified, and remains at 20 percent of the value of the Fund. The provision sunsets August 31, 2009.

Effective date.—The provision is effective for bonds issued after the date of enactment and before August 31, 2009.

SENATE AMENDMENT

The Senate amendment follows the House bill provision, and also increases the amount of bonds that may benefit from the exception to 30 percent of the value of the Fund.

Effective date.—The Senate amendment is the same as the House bill.

CONFERENCE AGREEMENT

The conference agreement includes the House bill provision.

G. Amortization of Expenses Incurred in Creating or Acquiring Music or Music Copyrights

(Sec. 468 of the Senate amendment and secs. 167(g) and 263A 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. Section 167(g) provides that the cost of motion picture films, sound recordings, copyrights, books, patents, and other property specified in regulations is eligible to be recovered using the income forecast method of depreciation.

Under the income forecast method, the depreciation deduction with respect to eligible property for a taxable year is determined by multiplying the adjusted basis of the property by a fraction, the numerator of which is the income generated by the property during the year, and the denominator of which is the total forecasted or estimated income expected to be generated prior to the close of the tenth taxable year after the year the property was placed in service. Any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year.

The adjusted basis of property that may be taken into account under the income forecast method includes only amounts that satisfy the economic performance standard of section 461(h) (except in the case of certain participations and residuals). In addition, taxpayers that claim depreciation deductions under the income forecast method are required to pay (or receive) interest based on a recalculation of depreciation under a "look-back" method.

The "look-back" method is applied in any "recomputation year" by (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of

the Code. Except as provided in Treasury regulations, a "recomputation year" is the third and tenth taxable year after the taxable year the property was placed in service, unless the actual income from the property for each taxable year ending with or before the close of such years was within 10 percent of the estimated income from the property for such years.

A special rule is provided under Treasury guidance in the case of certain authors and other taxpayers, with respect to their capitalization of costs under section 263A and with respect to the recovery or amortization of such costs. Specifically, IRS Notice 88–62 (1988–1 C.B. 548) provides an elective safe harbor under which eligible taxpayers capitalize qualified created costs incurred during the taxable year and amortize 50 percent of the costs in the taxable year incurred, and 25 percent in each of the two successive taxable years. Under the Notice, qualified creative costs generally are those incurred by a self-employed individual in the production of creative properties (such as films, sound recordings, musical and dance compositions including accompanying words, and other similar properties), provided the personal efforts of the individual predominantly create the properties. An eligible taxpayer is an individual, and also a corporation or partnership, substantially all of which is owned by one qualified employee owner (an individual and family members).

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment provides that if any expense is paid or incurred by the taxpayer in creating or acquiring any musical composition (including accompanying words) or any copyright with respect to a musical composition that is required to be capitalized, then the income forecast method does not apply to such expenses, but rather, the expenses are amortized over a five-year period. The five-year period is the period beginning with the month in which the composition or copyright was acquired (or if created, the five-taxable-year period beginning with the taxable year in which the expenses were paid or incurred).

The provision does not apply to certain expenses. The expenses to which it does not apply are expenses: (1) that are qualified creative expenses under section 263A(h); (2) to which a simplified procedure established under section 263A(j)(2) applies; (3) that are an amortizable section 197 intangible; or (4) that, without regard to this provision, would not be allowable as a deduction.

Effective date.—The provision is effective for expenses paid or incurred after December 31, 2005, in taxable years ending after that date.

CONFERENCE AGREEMENT

The conference agreement includes the Senate amendment provision with the following modifications. Under the conference agreement, the five-year amortization period is elective for the taxable year. Thus, a taxpayer that places in service any musical com-

position or copyright with respect to a musical composition in a taxable year may elect to apply the provision with respect to all musical compositions and musical composition copyrights placed in service in that taxable year. An eligible taxpayer that does not make the election may recover the costs under any method allowable under present law, including the income forecast method.

Under the conference agreement, the election may be made for any taxable year which begins before January 1, 2011.

In addition, the conference agreement provides that the five-year amortization period begins in the month the property is placed in service.

Effective date.—The conference agreement is effective for expenses paid or incurred with respect to property placed in service in taxable years beginning after December 31, 2005 and before January 1, 2011.

TITLE III—CHARITABLE PROVISIONS

A. Charitable Giving Incentives

1. Charitable deduction for nonitemizers; floor on deductions for itemizers (sec. 201 of the Senate amendment and secs. 63 and 170 of the Code)

PRESENT LAW

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3), to certain veterans' organizations, fraternal societies, and cemetery companies,[56] or to a Federal, State, or local governmental entity for exclusively public purposes.[57] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[58]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[59]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from

[56] Secs. 170(c)(3)–(5).
[57] Sec. 170(c)(1).
[58] Secs. 170(b) and (e).
[59] Sec. 170(a). The Economic Recovery Tax Act of 1981 adopted a temporary provision that permitted individual taxpayers who did not itemize income tax deductions to claim a deduction from gross income for a specified percentage of their charitable contributions. The maximum deduction was $25 for 1982 and 1983, $75 for 1984, 50 percent of the amount of the contribution for 1985, and 100 percent of the amount of the contribution for 1986. The nonitemizer deduction terminated for contributions made after 1986.

charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[60] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[61]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limit may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2006 is $150,500 ($77,250 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

[60] Sec. 170(f)(8).
[61] Sec. 6115.

HOUSE BILL

No provision.

SENATE AMENDMENT

Deduction for nonitemizers

In the case of an individual taxpayer who does not itemize deductions, the provision allows a "direct charitable deduction" from adjusted gross income for charitable contributions paid in cash during the taxable year. This deduction is allowed in addition to the standard deduction. The direct charitable deduction is the amount of the deduction allowable under section 170(a) for the taxable year for cash contributions (determined without regard to any carryover). The amount deductible under the provision is subject to the rules normally governing charitable contribution deductions, such as the substantiation requirements. In addition, the amount of the deduction is available only to the extent that the otherwise allowable direct charitable deduction exceeds the floor on charitable contributions, described below (i.e., $210 ($420 in the case of a joint return)). The deduction is allowed in computing alternative minimum taxable income.

The provision does not change the present-law rules regarding the carryover of charitable contributions to or from a taxable year, including a taxable year in which the taxpayer is allowed the direct contribution deduction.

Floor on itemized deductions

Under the provision, the amount of an individual's charitable contribution deduction (cash and noncash) is subject to a floor. The floor is $210 ($420 in the case of a joint return). In the case of an individual who elects to itemize deductions, the floor applies to the deduction otherwise allowed under section 170 for all contributions. In the case of an individual who does not elect to itemize deductions, the floor applies in determining the amount of the direct charitable deduction. The provision does not otherwise change the present-law rules pertaining to charitable contributions.

Effective date.—The provision is effective for contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

2. Tax-free distributions from individual retirement plans for charitable purposes (sec. 202 of the Senate amendment and secs. 408, 6034, 6104, and 6652 of the Code)

PRESENT LAW

In general

If an amount withdrawn from a traditional individual retirement arrangement ("IRA") or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals

from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions.

Charitable contributions

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3), to certain veterans' organizations, fraternal societies, and cemetery companies,[62] or to a Federal, State, or local governmental entity for exclusively public purposes.[63] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[64]

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.[65]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate, among other things, that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[66] In addition, present law requires that any charity that receives a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services may be deductible as a charitable contribution.[67]

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base, which is the taxpayer's adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50–percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30

[62] Secs. 170(c)(3)–(5).
[63] Sec. 170(c)(1).
[64] Secs. 170(b) and (e).
[65] Sec. 170(a).
[66] Sec. 170(f)(8).
[67] Sec. 6115.

percent of the taxpayer's contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer's contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer's contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limits may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2006 is $150,500 ($75,250 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.[68] Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.[69] For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

IRA rules

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not

[68] Secs. 170(f), 2055(e)(2), and 2522(c)(2).
[69] Sec. 170(f)(2).

qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59½ are subject to an additional 10-percent early withdrawal tax, unless an exception applies. Under present law, minimum distributions are required to be made from tax-favored retirement arrangements, including IRAs. Minimum required distributions from a traditional IRA must generally begin by the April 1 of the calendar year following the year in which the IRA owner attains age 70½.[70]

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;[71] (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

Distributions from an IRA (other than a Roth IRA) are generally subject to withholding unless the individual elects not to have withholding apply.[72] Elections not to have withholding apply are to be made in the time and manner prescribed by the Secretary.

Split-interest trust filing requirements

Split-interest trusts, including charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, are required to file an annual information return (Form 1041A).[73] Trusts that are not split-interest trusts but that claim a charitable deduction for amounts permanently set aside for a charitable purpose[74] also are required to file Form 1041A. The returns are required to be made publicly available.[75] A trust that is required to distribute all trust net income currently to trust beneficiaries in a taxable year is exempt from this return requirement for such tax-

[70] Minimum distribution rules also apply in the case of distributions after the death of a traditional or Roth IRA owner.
[71] Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.
[72] Sec. 3405.
[73] Sec. 6034. This requirement applies to all split-interest trusts described in section 4947(a)(2).
[74] Sec. 642(c).
[75] Sec. 6104(b).

able year. A failure to file the required return may result in a penalty on the trust of $10 a day for as long as the failure continues, up to a maximum of $5,000 per return.

In addition, split-interest trusts are required to file annually Form 5227.[76] Form 5227 requires disclosure of information regarding a trust's noncharitable beneficiaries. The penalty for failure to file this return is calculated based on the amount of tax owed. A split-interest trust generally is not subject to tax and therefore, in general, a penalty may not be imposed for the failure to file Form 5227. Form 5227 is not required to be made publicly available.

HOUSE BILL

No provision.

SENATE AMENDMENT

Qualified charitable distributions from IRAs

The provision provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions.[77] Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The present-law rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions. Qualified charitable distributions are taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the provision. An IRA does not fail to qualify as an IRA merely because qualified charitable distributions have been made from the IRA. It is intended that the Secretary will prescribe rules under which IRA owners are deemed to elect out of withholding if they designate that a distribution is intended to be a qualified charitable distribution.

A qualified charitable distribution is any distribution from an IRA that is made after December 31, 2005, and before January 1, 2008, directly by the IRA trustee either to (1) an organization to which deductible contributions can be made (a "direct distribution") or (2) a "split-interest entity." A split-interest entity means a charitable remainder annuity trust or charitable remainder unitrust (together referred to as a "charitable remainder trust"), a pooled income fund, or a charitable gift annuity. Direct distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70½. Distributions to a split interest entity are eligible for the exclusion only if made on or after the date the IRA owner attains age 59½. In the case of distributions to split-interest distributions, no person may hold an income interest in the amounts in the split-interest entity attributable to the charitable distribution other than the IRA owner, the IRA owner's spouse, or a charitable organization.

[76] Sec. 6011; Treas. Reg. sec. 53.6011–1(d).

[77] The provision does not apply to distributions from employer-sponsored retirements plans, including SIMPLE IRAs and simplified employee pensions ("SEPs").

The exclusion applies to direct distributions only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution. Similarly, the exclusion applies in the case of a distribution directly to a split-interest entity only if a charitable contribution deduction for the entire present value of the charitable interest (for example, a remainder interest) otherwise would be allowable, determined without regard to the generally applicable percentage limitations.

If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the provision) and thus is eligible for qualified charitable distribution treatment. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the provision) if the aggregate balance of all IRAs having the same owner were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are to be made to reflect the amount treated as a qualified charitable distribution under the special rule.

Special rules apply for distributions to split-interest entities. For distributions to charitable remainder trusts, the provision provides that subsequent distributions from the charitable remainder trust are treated as ordinary income in the hands of the beneficiary, notwithstanding how such amounts normally are treated under section 664(b). In addition, for a charitable remainder trust to be eligible to receive qualified charitable distributions, the charitable remainder trust has to be funded exclusively by such distributions. For example, an IRA owner may not make qualified charitable distributions to an existing charitable remainder trust any part of which was funded with assets that were not qualified charitable distributions.

Under the provision, a pooled income fund is eligible to receive qualified charitable distributions only if the fund accounts separately for amounts attributable to such distributions. In addition, all distributions from the pooled income fund that are attributable to qualified charitable distributions are treated as ordinary income to the beneficiary. Qualified charitable distributions to a pooled income fund are not includible in the fund's gross income.

In determining the amount includible in gross income by reason of a payment from a charitable gift annuity purchased with a qualified charitable distribution from an IRA, the portion of the distribution from the IRA used to purchase the annuity is not an investment in the annuity contract.

Any amount excluded from gross income by reason of the provision is not taken into account in determining the deduction for charitable contributions under section 170.

Qualified charitable distribution examples

The following examples illustrate the determination of the portion of an IRA distribution that is a qualified charitable distribution and the application of the special rules for a qualified charitable distribution to a split-interest entity. In each example, it is assumed that the requirements for qualified charitable distribution treatment are otherwise met (e.g., the applicable age requirement and the requirement that contributions are otherwise deductible) and that no other IRA distributions occur during the year.

Example 1.—Individual A has a traditional IRA with a balance of $100,000, consisting solely of deductible contributions and earnings. Individual A has no other IRA. The entire IRA balance is distributed in a direct distribution to a charitable organization. Under present law, the entire distribution of $100,000 would be includible in Individual A's income. Accordingly, under the provision, the entire distribution of $100,000 is a qualified charitable distribution. As a result, no amount is included in Individual A's income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual A's charitable deduction for the year.

Example 2.—The facts are the same as in Example 1, except that the entire IRA balance of $100,000 is distributed to a charitable remainder unitrust, which contains no other assets and which must be funded exclusively by qualified charitable distributions. Under the terms of the trust, Individual A is entitled to receive five percent of the net fair market value of the trust assets each year. As explained in Example 1, the entire $100,000 distribution is a qualified charitable distribution, no amount is included in Individual A's income as a result of the distribution, and the distribution is not taken into account in determining the amount of Individual A's charitable deduction for the year. In addition, under a special rule in the provision for charitable remainder trusts, any distribution from the charitable remainder unitrust to Individual A is includible in gross income as ordinary income, regardless of the character of the distribution under the usual rules for the taxation of distributions from such a trust.

Example 3.—Individual B has a traditional IRA with a balance of $100,000, consisting of $20,000 of nondeductible contributions and $80,000 of deductible contributions and earnings. Individual B has no other IRA. In a direct distribution to a charitable organization, $80,000 is distributed from the IRA. Under present law, a portion of the distribution from the IRA would be treated as a nontaxable return of nondeductible contributions. The nontaxable portion of the distribution would be $16,000, determined by multiplying the amount of the distribution ($80,000) by the ratio of the nondeductible contributions to the account balance ($20,000/$100,000). Accordingly, under present law, $64,000 of the distribution ($80,000 minus $16,000) would be includible in Individual B's income.

Under the provision, notwithstanding the present-law tax treatment of IRA distributions, the distribution is treated as consisting of income first, up to the total amount that would be includible in gross income (but for the provision) if all amounts were distributed from all IRAs otherwise taken into account in determining

the amount of IRA distributions. The total amount that would be includible in income if all amounts were distributed from the IRA is $80,000. Accordingly, under the provision, the entire $80,000 distributed to the charitable organization is treated as includible in income (before application of the provision) and is a qualified charitable distribution. As a result, no amount is included in Individual B's income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual B's charitable deduction for the year. In addition, for purposes of determining the tax treatment of other distributions from the IRA, $20,000 of the amount remaining in the IRA is treated as Individual B's nondeductible contributions (i.e., not subject to tax upon distribution).

Split-interest trust filing requirements

The provision increases the penalty on split-interest trusts for failure to file a return and for failure to include any of the information required to be shown on such return and to show the correct information. The penalty is $20 for each day the failure continues up to $10,000 for any one return. In the case of a split-interest trust with gross income in excess of $250,000, the penalty is $100 for each day the failure continues up to a maximum of $50,000. In addition, if a person (meaning any officer, director, trustee, employee, or other individual who is under a duty to file the return or include required information)[78] knowingly failed to file the return or include required information, then that person is personally liable for such a penalty, which would be imposed in addition to the penalty that is paid by the organization. Information regarding beneficiaries that are not charitable organizations as described in section 170(c) is exempt from the requirement to make information publicly available. In addition, the provision repeals the present-law exception to the filing requirement for split-interest trusts that are required in a taxable year to distribute all net income currently to beneficiaries. Such exception remains available to trusts other than split-interest trusts that are otherwise subject to the filing requirement.

Effective date

The provision relating to qualified charitable distributions is effective for distributions made in taxable years beginning after December 31, 2005, and before January 1, 2008. The provision relating to information returns of split-interest trusts is effective for returns for taxable years beginning after December 31, 2005.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

[78] Sec. 6652(c)(4)(C).

3. Charitable deduction for contributions of food inventory (sec. 203 of the Senate amendment and sec. 170 of the Code)

PRESENT LAW

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (*i.e.,* basis plus one half of fair market value in excess of basis) or (2) two times basis (sec. 170(e)(3)). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income (sec. 170(b)(2)). To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory (Treas. Reg. sec. 1.170A–4A(c)(3)). Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of disputes between taxpayers and the IRS.[79]

Under the Katrina Emergency Tax Relief Act of 2005, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for certain donations made after August 28, 2005, and before January 1, 2006, of food inventory. For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other entity that is not a C corporation) from which contributions of "apparently wholesome food" are made. "Ap-

[79] *Lucky Stores Inc.* v. *Commissioner,* 105 T.C. 420 (1995) (holding that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted).

parently wholesome food" is defined as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

HOUSE BILL

No provision.

SENATE AMENDMENT

Extension of Katrina Emergency Tax Relief Act of 2005

The provision extends the provision enacted as part of the Katrina Emergency Tax Relief Act of 2005. As under such Act, under the provision, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for donations of food inventory. For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other non C corporation) from which contributions of apparently wholesome food are made. For example, as under the Katrina Emergency Tax Relief Act of 2005, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the taxpayer's interest in the S corporation, but not the taxpayer's interest in the partnership.[80]

Under the provision, the enhanced deduction for food is available only for food that qualifies as "apparently wholesome food." "Apparently wholesome food" is defined as it is defined under the Katrina Emergency Tax Relief Act of 2005.

Modifications to enhanced deduction for food inventory

Under the provision, for purposes of calculating the enhanced deduction, taxpayers that do not account for inventories under section 471 and that are not required to capitalize indirect costs under section 263A are able to elect to treat the basis of the contributed food as being equal to 25 percent of the food's fair market value.[81]

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[80] The 10 percent limitation does not affect the application of the generally applicable percentage limitations. For example, if 10 percent of a sole proprietor's net income from the proprietor's trade or business was greater than 50 percent of the proprietor's contribution base, the available deduction for the taxable year (with respect to contributions to public charities) would be 50 percent of the proprietor's contribution base. Consistent with present law, such contributions may be carried forward because they exceed the 50 percent limitation. Contributions of food inventory by a taxpayer that is not a C corporation that exceed the 10 percent limitation but not the 50 percent limitation could not be carried forward.

[81] This includes, for example, taxpayers who are eligible for administrative relief under Revenue Procedures 2002–28 and 2001–10.

The provision changes the amount of the enhanced deduction for eligible contributions of food inventory to the lesser of fair market value or twice the taxpayer's basis in the inventory. For example, a taxpayer who makes an eligible donation of food that has a fair market value of $10 and a basis of $4 could take a deduction of $8 (twice basis). If the taxpayer's basis is $6 instead of $4, then the deduction would be $10 (fair market value). By contrast, under present law, a C corporation's deduction in the first example would be $7 (fair market value less half the appreciation) and in the second example would be $8. (Except for contributions made after August 28, 2005, and before January 1, 2006, taxpayers other than C corporations generally could take a deduction for a contribution of food inventory only for the $4 basis in either example.)

The provision provides that the fair market value of donated apparently wholesome food that cannot or will not be sold solely due to internal standards of the taxpayer or lack of market is determined without regard to such internal standards or lack of market and by taking into account the price at which the same or substantially the same food items (as to both type and quality) are sold by the taxpayer at the time of the contribution or, if not so sold at such time, in the recent past.

Effective date

The provision is effective for contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

4. Basis adjustment to stock of S corporation contributing property (sec. 204 of the Senate amendment and sec. 1367 of the Code)

PRESENT LAW

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.[82] A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.[83]

HOUSE BILL

No provision.

SENATE AMENDMENT

The provision provides that the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation will be equal to the

[82] Sec. 1366(a)(1)(A).
[83] Sec. 1367(a)(2)(B).

shareholder's pro rata share of the adjusted basis of the contributed property.[84]

Thus, for example, assume an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of $200 and a fair market value of $500. The shareholder will be treated as having made a $500 charitable contribution (or a lesser amount if the special rules of section 170(e) apply), and will reduce the basis of the S corporation stock by $200.[85]

Effective date.—The provision applies to contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

5. Charitable deduction for contributions of book inventory (sec. 205 of the Senate amendment and sec. 170 of the Code)

PRESENT LAW

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis (sec. 170(e)(3)). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income (sec. 170(b)(2)). To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory (Treas. Reg. sec. 1.170A–4A(c)(3)). Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value,

[84] See Rev. Rul. 96–11 (1996–1 C.B. 140) for a rule reaching a similar result in the case of charitable contributions made by a partnership.

[85] This example assumes that basis of the S corporation stock (before reduction) is at least $200.

with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis.

The Katrina Emergency Tax Relief Act of 2005 extended the present-law enhanced deduction for C corporations to certain qualified book contributions made after August 28, 2005, and before January 1, 2006. For such purposes, a qualified book contribution means a charitable contribution of books to a public school that provides elementary education or secondary education (kindergarten through grade 12) and that is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The enhanced deduction under the Katrina Emergency Tax Relief Act of 2005 is not allowed unless the donee organization certifies in writing that the contributed books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs.

HOUSE BILL

No provision.

SENATE AMENDMENT

The provision modifies the present-law enhanced deduction for C corporations so that it is equal to the lesser of fair market value or twice the taxpayer's basis in the case of qualified book contributions. The provision provides that the fair market value for this purpose is determined by reference to a bona fide published market price for the book. Under the provision, a bona fide published market price of a book is a price of a book, determined using the same printing and same edition, published within seven years preceding the contribution, determined as a result of an arm's length transaction, and for which the book was customarily sold. For example, a publisher's listed retail price for a book would not meet the standard if the publisher could not demonstrate to the satisfaction of the Secretary that the price was one at which the book was customarily sold and was the result of an arm's length transaction. If a publisher entered into a contract with a local school district to sell newly published textbooks six years prior to making a qualified book contribution of such textbooks, the publisher could use as a bona fide published market price, the price at which such books regularly were sold to the school district under the contract. By contrast, if a publisher listed in a catalogue or elsewhere a "suggested retail price," but books were not in fact customarily sold at such price, the publisher could not use the "suggested retail price" to determine the fair market value of the book for purposes of the enhanced deduction. Thus, in general, a bona fide published market price must be independently verifiable by reference to actual sales within the seven-year period preceding the contribution, and not to a publisher's own price list.

As an illustration of the mechanics of calculating the enhanced deduction under the provision, a C corporation that made a qualified book contribution with a bona fide published market price of $10 and a basis of $4 could take a deduction of $8 (twice basis). If the taxpayer's basis is $6 instead of $4, then the deduction is $10. Also, in such latter case, if the book's bona fide published market price was $5 at the time of the contribution but was $10 five years before the contribution, then the deduction is $10.

A qualified book contribution means a charitable contribution of books to: (1) an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on; (2) a public library; or (3) an organization described in section 501(c)(3) (except for private nonoperating foundations), that is organized primarily to make books available to the general public at no cost or to operate a literacy program. The donee must: (1) use the property consistent with the donee's exempt purpose; (2) not transfer the property in exchange for money, other property, or services; and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements and also that the books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs.

Effective date.—The provision is effective for contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

6. Modify tax treatment of certain payments to controlling exempt organizations and public disclosure of information relating to UBIT (sec. 206 of the Senate amendment and secs. 512, 6011, 6104, and new sec. 6720C of the Code)

PRESENT LAW

Payments to controlling exempt organizations

In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations. However, section 512(b)(13) generally treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization. In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power

or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

Under present law, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includable in the latter organization's unrelated business income and are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt).

The Taxpayer Relief Act of 1997 (the "1997 Act") made several modifications to the control requirement of section 512(b)(13). In order to provide transitional relief, the changes made by the 1997 Act do not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment of the 1997 Act (August 5, 1997) if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

Public disclosure of returns

In general, an organization described in section 501(c) or (d) is required to make available for public inspection a copy of its annual information return (Form 990) and exemption application materials.[86] A penalty may be imposed on any person who does not make an organization's annual returns or exemption application materials available for public inspection. The penalty amount is $20 for each day during which a failure occurs. If more than one person fails to comply, each person is jointly and severally liable for the full amount of the penalty. The maximum penalty that may be imposed on all persons for any one annual return is $10,000. There is no maximum penalty amount for failing to make exemption application materials available for public inspection. Any person who willfully fails to comply with the public inspection requirements is subject to an additional penalty of $5,000.[87]

These requirements do not apply to an organization's annual return for unrelated business income tax (generally Form 990–T).[88]

HOUSE BILL

No provision.

SENATE AMENDMENT

Payments to controlling exempt organizations

The provision provides that the general rule of section 512(b)(13), which includes interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization in the latter organization's unrelated business income to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity, applies only to the portion of payments received or accrued in a taxable year that exceed

[86] Sec. 6104(d).
[87] Sec. 6685.
[88] Treas. Reg. sec. 301.6104(d)–1(b)(4)(ii).

the amount of the specified payment that would have been paid or accrued if such payment had been determined under the principles of section 482. Thus, if a payment of rent by a controlled subsidiary to its tax-exempt parent organization exceeds fair market value, the excess amount of such payment over fair market value (as determined in accordance with section 482) is included in the parent organization's unrelated business income, to the extent that such excess reduced the net unrelated income (or increased any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt). In addition, the provision imposes a 20-percent penalty on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

The provision provides that if modifications to section 512(b)(13) made by the 1997 Act did not apply to a contract because of the transitional relief provided by the 1997 Act, then such modifications also do not apply to amounts received or accrued under such contract before January 1, 2001.

Require public availability of unrelated business income tax returns

The provision extends the present-law public inspection and disclosure requirements and penalties applicable to the Form 990 to the unrelated business income tax return (Form 990–T) of organizations described in section 501(c)(3). The provision provides that certain information may be withheld by the organization from public disclosure and inspection if public availability would adversely affect the organization, similar to the information that may be withheld under present law with respect to applications for tax exemption and the Form 990 (e.g., information relating to a trade secret, patent, process, style of work, or apparatus of the organization, if the Secretary determines that public disclosure of such information would adversely affect the organization).

Require a UBIT certification for certain large charitable organizations

Under the provision, a charitable organization that has annual total gross income and receipts (including, e.g., contributions and grants, program service revenue, investment income, and revenues from an unrelated trade or business or other sources) or gross assets of at least $10 million on the last day of the taxable year must include with its Form 990 and Form 990–T filings (if any) a statement by an independent auditor or an independent counsel that (1) contains a certification that the information contained in the return has been reviewed by the auditor or counsel and, to the best of his or her knowledge, is accurate; (2) to the best of the auditor's or counsel's knowledge, the allocation of expenses between the exempt and the unrelated business income activities of the organization comply with the requirements set forth by the Secretary under section 512; and (3) indicates whether the auditor or counsel has provided a tax opinion to the organization regarding the classification of any trade or business of the organization as an unrelated trade or business or the treatment of any income as unrelated business taxable income and a description of any material facts with respect to any such opinion.

Failure to file the required statement results in a penalty, imposed on the organization, of one half of one percent (0.5 percent) of the organization's total gross revenues for the taxable year, excluding revenues from contributions and grants. No penalty is imposed with respect to any failure that is due to reasonable cause.

Effective date.—The provision related to payments to controlling organizations applies to payments received or accrued after December 31, 2000. The public availability requirements of the provision apply to returns filed after the date of enactment. The certification requirement applies to returns for taxable years beginning after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

7. Encourage contributions of real property made for conservation purposes (sec. 207 of the Senate amendment and sec. 170 of the Code)

PRESENT LAW

Charitable contributions generally

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.[89]

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's taxable income computed without regard to net operating or capital loss carrybacks. For individuals, the amount deductible is a percentage of the taxpayer's contribution base, which is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base. Cash contributions to private foundations and certain other organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while also either retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration. Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, present interests in the form of a guaranteed annuity or a fixed percentage of the an-

[89] Secs. 170, 2055, and 2522, respectively.

nual value of the property, and qualified conservation contributions.

Capital gain property

Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (*e.g.*, public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (*e.g.*, private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

Qualified conservation contributions

Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryover rules of other charitable contributions of capital gain property.

HOUSE BILL

No provision.

SENATE AMENDMENT

In general

Under the provision, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in section 170(b)(1)(A) to the extent of the excess of 50-percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions.

Individuals are allowed to carryover any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years.

For example, assume an individual with a contribution base of $100 makes a qualified conservation contribution of property with a fair market value of $80 and makes other charitable contributions subject to the 50-percent limitation of $60. The individual is allowed a deduction of $50 in the current taxable year for the non-conservation contributions (50 percent of the $100 contribution base) and is allowed to carryover the excess $10 for up to 5 years. No current deduction is allowed for the qualified conservation contribution, but the entire $80 qualified conservation contribution may be carried forward for up to 15 years.

Farmers and ranchers

Individuals

In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the above example, if the individual is a qualified farmer or rancher, in addition to the $50 deduction for non-conservation contributions, an additional $50 for the qualified conservation contribution is allowed and $30 may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.

Corporations

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.

Definition

A qualified farmer or rancher means a taxpayer whose gross income from the trade of business of farming (within the meaning of section 2032A(e)(5)) is greater than 50 percent of the taxpayer's gross income for the taxable year.

Effective date.

The provision applies to contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

8. Enhanced deduction for charitable contributions of literary, musical, artistic, and scholarly compositions (sec. 208 of the Senate amendment 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 deduction generally is limited to the taxpayer's basis in the property.[90] 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 of tangible personal property to a private foundation (other than certain private foundations),[91] the amount of the deduction is limited to the taxpayer's basis in the property.

Under present law, charitable contributions of literary, musical, and artistic compositions created or prepared by the donor are considered ordinary income property and a taxpayer's deduction of such property is limited to the taxpayer's basis (typically, cost) in the property. A charitable contribution of a literary, musical, or artistic composition by a person other than the person who created or prepared the work generally is eligible for a fair market value deduction if the donee organization's use of the property is related to such organization's exempt purposes.

To be eligible for the deduction, the contribution must be of an undivided portion of the donor's entire interest in the property.[92] For purposes of the charitable income tax deduction, the copyright and the work in which the copyright is embodied are not treated as separate property interests. Accordingly, if a donor owns a work of art and the copyright to the work of art, a gift of the artwork without the copyright or the copyright without the artwork will constitute a gift of a "partial interest" and will not qualify for the income tax charitable deduction.

HOUSE BILL

No provision.

[90] Sec. 170(e)(1).
[91] Sec. 170(e)(1)(B)(ii).
[92] Sec. 170(f)(3).

SENATE AMENDMENT

The provision provides that a deduction for "qualified artistic charitable contributions" generally is increased from the value under present law (generally, basis) to the fair market value of the property contributed, measured at the time of the contribution. However, the amount of the increase of the deduction provided by the provision may not exceed the amount of the donor's adjusted gross income for the taxable year attributable to: (1) income from the sale or use of property created by the personal efforts of the donor that is of the same type as the donated property; and (2) income from teaching, lecturing, performing, or similar activities with respect to such property. In addition, the increase to the present-law deduction provided by the provision may not be carried over and deducted in other taxable years.

The provision defines a qualified artistic charitable contribution to mean a charitable contribution of any literary, musical, artistic, or scholarly composition, or similar property, or the copyright thereon (or both) that meets certain requirements. First, the contributed property must have been created by the personal efforts of the donor at least 18 months prior to the date of contribution. Second, the donor must obtain a qualified appraisal of the contributed property, a copy of which is required to be attached to the donor's income tax return for the taxable year in which such contribution is made. The appraisal must include evidence of the extent (if any) to which property created by the personal efforts of the taxpayer and of the same type as the donated property is or has been owned, maintained, and displayed by certain charitable organizations and sold to or exchanged by persons other than the taxpayer, donee, or any related person. Third, the contribution must be made to a public charity or to certain limited types of private foundations (i.e., an organization described in section 170(b)(1)(A)). Finally, the use of donated property by the recipient organization must be related to the organization's charitable purpose or function, and the donor must receive a written statement from the organization verifying such use.

Under the provision, the tangible property and the copyright on such property are treated as separate properties for purposes of the "partial interest" rule; thus, a gift of artwork without the copyright or a copyright without the artwork does not constitute a gift of a partial interest and is deductible. Contributions of letters, memoranda, or similar property that are written, prepared, or produced by or for an individual while the individual is an officer or employee of any person (including a government agency or instrumentality) do not qualify for a fair market value deduction unless the contributed property is entirely personal.

Effective date.—The deduction for qualified artistic charitable contributions applies to contributions made after December 31, 2005, and before January 1, 2008.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

9. Mileage reimbursements to charitable volunteers excluded from gross income (sec. 209 of the Senate amendment and new sec. 139B of the Code)

PRESENT LAW

In general, an itemized deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. Unreimbursed out-of-pocket expenditures made incident to providing donated services to a qualified charitable organization—such as out-of-pocket transportation expenses necessarily incurred in performing donated services—may qualify as a charitable contribution.[93] No charitable contribution deduction is allowed for traveling expenses (including expenses for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel.[94]

In determining the amount treated as a charitable contribution where a taxpayer operates a vehicle to provide donated services to a charity, the taxpayer either may deduct actual out-of-pocket expenditures or, in the case of a passenger automobile, may use the charitable standard mileage rate. The charitable standard mileage rate is set by statute at 14 cents per mile.[95] The taxpayer may also deduct (under either computation method), any parking fees and tolls incurred in rendering the services, but may not deduct any amount (regardless of the computation method used) for general repair or maintenance expenses, depreciation, insurance, registration fees, etc. Regardless of the computation method used, the taxpayer must keep reliable written records of expenses incurred. For example, where a taxpayer uses the charitable standard mileage rate to determine a deduction, the IRS has stated that the taxpayer generally must maintain records of miles driven, time, place (or use), and purpose of the mileage. If the charitable standard mileage rate is not used to determine the deduction, the taxpayer generally must maintain reliable written records of actual expenses incurred.

In lieu of actual operating expenses, an optional standard mileage rate may be used in computing the deductible costs of business use of an automobile. The business standard mileage rate is determined by the IRS and updated periodically. For business use occurring on or after January 1, 2006, the business standard mileage rate specified by the IRS is 44.5 cents per mile.

The standard mileage rate for charitable purposes is lower than the standard business rate because the charitable rate covers only the out-of-pocket operating expenses (including gasoline and oil) directly related to the use of the automobile in performing the donated services that a taxpayer may deduct as a charitable contribution. The charitable rate does not include costs that are not deductible as a charitable contribution such as general repair or maintenance expenses, depreciation, insurance, and registration fees. Such costs are, however, included in computing the business standard mileage rate.

[93] Treas. Reg. sec. 1.170A–1(g).
[94] Sec. 170(j).
[95] Sec. 170(i).

Volunteer drivers who are reimbursed for mileage expenses have taxable income to the extent the reimbursement exceeds deductible travel expenses. Employees who are reimbursed for mileage expenses under a qualified arrangement that pays a mileage allowance in lieu of reimbursing actual expenses generally have taxable income to the extent the reimbursement exceeds the amount of the business standard mileage rate multiplied by the actual business miles.

Under section 6041, information reporting generally is required with respect to payments of $600 or more in any taxable year.

Under the Katrina Emergency Tax Relief Act of 2005, reimbursement by an organization described in section 170(c) (including public charities and private foundations) to a volunteer for the costs of using a passenger automobile in providing donated services to charity solely for the provision of relief related to Hurricane Katrina is excludable from the gross income of the volunteer up to an amount that does not exceed the business standard mileage rate prescribed for business use (as periodically adjusted), provided that recordkeeping requirements applicable to deductible business expenses are satisfied. The Katrina Emergency Tax Relief Act of 2005 does not permit a volunteer to claim a deduction or credit with respect to such amounts excluded. The provision applies for purposes of use of a passenger automobile during the period beginning on August 25, 2005, and ending on December 31, 2006.

HOUSE BILL

No provision.

SENATE AMENDMENT

The provision extends the provision enacted as part of the Katrina Emergency Tax Relief Act of 2005. Under the provision, reimbursement by an organization described in section 170(c) (including public charities and private foundations) to a volunteer for the costs of using a passenger automobile in providing donated services to charity is excludable from the gross income of the volunteer up to an amount that does not exceed the business standard mileage rate prescribed for business use (as periodically adjusted), provided that recordkeeping requirements applicable to deductible business expenses are satisfied. Unlike the provision enacted as part of the Katrina Emergency Tax Relief Act of 2005, the provision is not limited to use solely for the provision of relief related to Hurricane Katrina. The provision does not permit a volunteer to claim a deduction or credit with respect to amounts excluded under the provision. Information reporting required by section 6041 is not required with respect to reimbursements excluded under the provision.

Effective date.—The provision applies for taxable years beginning after December 31, 2005, and beginning before January 1, 2008.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

10. Alternative percentage limitation for corporate charitable contributions to the mathematics and science partnership program (sec. 210 of the Senate amendment and sec. 170 of the Code)

PRESENT LAW

Under present law, a corporation is allowed to deduct charitable contributions up to 10 percent of the corporation's modified taxable income for the year. For this purpose, taxable income is determined without regard to (1) the charitable contributions deduction, (2) any net operating loss carryback, (3) deductions for dividends received, and (4) any capital loss carryback for the taxable year.[96] Any charitable contribution by a corporation that is not currently deductible because of the percentage limitation may be carried forward for up to five taxable years.

HOUSE BILL

No provision.

SENATE AMENDMENT

Under the provision, the corporate percentage limitation is applied separately to eligible mathematics and science contributions and to all other charitable contributions. In addition, the applicable percentage limitation for purposes of eligible mathematics and science contributions is 15 percent; the applicable percentage limitation for all other corporate charitable contributions remains 10 percent.

In general, an eligible mathematics and science contribution is a charitable contribution (other than a contribution of used equipment) to a qualified partnership for the purpose of an activity described in section 2202(c) of the Elementary and Secondary Education Act of 1965. Such activities include, for example, creating opportunities for enhanced and ongoing professional development of mathematics and science teachers and promoting strong teaching skills for mathematics and science teachers and teacher educators. A qualified partnership is an eligible partnership within the meaning of section 2201(b)(1) of the Elementary and Secondary Education Act of 1965, but only to the extent that such partnership does not include a person other than a person described in section 170(b)(1)(A) (describing organizations to which individuals may make charitable contributions deductible up to 50 percent of such individual's contribution base).

Effective date.—The provision applies for contributions made in taxable years beginning after December 31, 2005, and beginning before January 1, 2007.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

[96] Sec. 170(b)(2).

B. Reforming Charitable Organizations

1. Tax involvement of accommodation parties in tax-shelter transactions (sec. 211 of the Senate amendment and secs. 6011, 6033, 6652, and new sec. 4965 of the Code)

PRESENT LAW

Disclosure of listed and other reportable transactions by taxpayers

Present law provides that a taxpayer that participates in a reportable transaction (including a listed transaction) and that is required to file a tax return must attach to its return a disclosure statement in the form prescribed by the Secretary.[97] For this purpose, the term taxpayer includes any person, including an individual, trust, estate, partnership, association, company, or corporation.[98]

Under present Treasury regulations, a reportable transaction includes a listed transaction and five other categories of transactions: (1) confidential transactions, which are transactions offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a minimum fee; (2) transactions with contractual protection, which include transactions for which the taxpayer or a related party has the right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained, or for which fees are contingent on the taxpayer's realization of tax benefits from the transaction; (3) loss transactions, which are transactions resulting in the taxpayer claiming a loss under section 165 that exceeds certain thresholds, depending upon the type of taxpayer; (4) transactions with a significant book-tax difference; and (5) transactions involving a brief asset holding period.[99] A listed transaction means a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011 (relating to the filing of returns and statements), and identified by notice, regulation, or other form of published guidance as a listed transaction.[100] The fact that a transaction is a reportable transaction does not affect the legal determination of whether the taxpayer's treatment of the transaction is proper.[101] Present law authorizes the Secretary to define a reportable transaction on the basis of such transaction being of a type which the Secretary determines as having a potential for tax avoidance or evasion.[102]

Treasury regulations provide guidance regarding the determination of when a taxpayer participates in a transaction for these purposes.[103] A taxpayer has participated in a listed transaction if the taxpayer's tax return reflects tax consequences or a tax strategy described in the published guidance that lists the transaction,

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[97] Treas. Reg. sec. 1.6011–4(a).
[98] Sec. 7701(a)(1); Treas. Reg. sec. 1.6011–4(c)(1).
[99] Treas. Reg. sec. 1.6011–4(b). In Notice 2006–6 (January 6, 2006), the Service indicated that it was removing transactions with a significant book-tax difference from the categories of reportable transactions.
[100] Sec. 6707A(c)(2); Treas. Reg. sec. 1.6011–4(b)(2).
[101] Treas. Reg. sec. 1.6011–4(a).
[102] Sec. 6707A(c)(1).
[103] Treas. Reg. sec. 1.6011–4(c)(3).

or if the taxpayer knows or has reason to know that the taxpayer's tax benefits are derived directly or indirectly from tax consequences of a tax strategy described in published guidance that lists a transaction. A taxpayer has participated in a confidential transaction if the taxpayer's tax return reflects a tax benefit from the transaction and the taxpayer's disclosure of the tax treatment or tax structure of the transaction is limited under conditions of confidentiality. A taxpayer has participated in a transaction with contractual protection if the taxpayer's tax return reflects a tax benefit from the transaction, and the taxpayer has the right to the full or partial refund of fees or the fees are contingent.

Present law provides a penalty for any person who fails to include on any return or statement any required information with respect to a reportable transaction.[104] The penalty applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any other penalty that may be imposed.

The penalty for failing to disclose a reportable transaction is $10,000 in the case of a natural person and $50,000 in any other case. The amount is increased to $100,000 and $200,000, respectively, if the failure is with respect to a listed transaction. The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the IRS Commissioner may rescind all or a portion of the penalty if rescission would promote compliance with the tax laws and effective tax administration.

Disclosure of listed and other reportable transactions by material advisors

Present law requires each material advisor with respect to any reportable transaction (including any listed transaction) to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe).[105] The information return must include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. The return must be filed by the date specified by the Secretary.

A "material advisor" means any person (1) who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of $250,000 ($50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons) or such other amount as may be prescribed by the Secretary for such advice or assistance.[106]

The Secretary may prescribe regulations which provide (1) that only one material advisor is required to file an information return in cases in which two or more material advisors would otherwise be required to file information returns with respect to a particular reportable transaction, (2) exemptions from the requirements of

[104] Sec. 6707A.
[105] Sec. 6707(a), as added by the American Jobs Creation Act of 2004, Pub. L. No. 108–357, sec. 816(a).
[106] Sec. 6707(b)(1).

this section, and (3) other rules as may be necessary or appropriate to carry out the purposes of this section.[107]

Present law imposes a penalty on any material advisor who fails to timely file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).[108] The amount of the penalty is $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the gross income derived by such person with respect to aid, assistance, or advice which is provided with respect to the transaction before the date the information return that includes the transaction is filed. An intentional failure or act by a material advisor with respect to the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income derived from the transaction.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the IRS Commissioner can rescind all or a portion of the penalty if rescission would promote compliance with the tax laws and effective tax administration.

HOUSE BILL

No provision.

SENATE AMENDMENT

In general

In general, under the provision, certain tax-exempt entities are subject to penalties for being a party to a prohibited tax shelter transaction. A prohibited tax shelter transaction is a transaction that the Secretary determines is a listed transaction (as defined in section 6707A(c)(2)) or a prohibited transaction. A prohibited reportable transaction is a confidential transaction or a transaction with contractual protection (as defined by the Secretary in regulations) which is a reportable transaction as defined in sec. 6707A(c)(1). Under the provision, a tax-exempt entity is an entity that is described in section 501(c), 501(d), or 170(c) (not including the United States), Indian tribal governments, and tax qualified pension plans, individual retirement arrangements ("IRAs"), and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and qualified tuition plans).

Entity level tax

Under the provision, if a tax-exempt entity is a party at any time to a transaction during a taxable year and knows or has reason to know that the transaction is a prohibited tax shelter transaction, the entity is subject to a tax for such year equal to the greater of (1) 100 percent of the entity's net income (after taking into account any tax imposed with respect to the transaction) for such year that is attributable to the transaction or (2) 75 percent of the proceeds received by the entity that are attributable to the transaction.

[107] Sec. 6707(c).
[108] Sec. 6707(b).

In addition, if a transaction is not a listed transaction at the time a tax-exempt entity enters into the transaction (and is not otherwise a prohibited tax shelter transaction), but the transaction subsequently is determined by the Secretary to be a listed transaction (a "subsequently listed transaction"), the entity must pay each taxable year an excise tax at the highest unrelated business taxable income rate times the greater of (1) the entity's net income (after taking into account any tax imposed) that is attributable to the subsequently listed transaction and that is properly allocable to the period beginning on the later of the date such transaction is listed by the Secretary or the first day of the taxable year or (2) 75 percent of the proceeds received by the entity that are attributable to the subsequently listed transaction and that are properly allocable to the period beginning on the later of the date such transaction is listed by the Secretary or the first day of the taxable year. The Secretary has the authority to promulgate regulations that provide guidance regarding the determination of the allocation of net income of a tax-exempt entity that is attributable to a transaction to various periods, including before and after the listing of the transaction or the date which is 90 days after the date of enactment of the provision.

The entity level tax does not apply if the entity's participation is not willful and is due to reasonable cause, except that the willful and reasonable cause exception does not apply to the tax imposed for subsequently listed transactions. The entity level taxes do not apply to tax qualified pension plans, IRAs, and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and qualified tuition plans).

Disclosure of participation in prohibited tax shelter transactions

The provision requires that a taxable party to a prohibited tax shelter transaction disclose to the tax-exempt entity that the transaction is a prohibited tax shelter transaction. Failure to make such disclosure is subject to the present-law penalty for failure to include reportable transaction information under section 6707A. Thus, the penalty is $10,000 in the case of a natural person or $50,000 in any other case, except that if the transaction is a listed transaction, the penalty is $100,000 in the case of a natural person and $200,000 in any other case.[109]

The provision requires disclosure by a tax-exempt entity to the IRS of each participation in a prohibited tax shelter transaction and disclosure of other known parties to the transaction. The penalty for failure to disclose is imposed on the entity (or entity manager, in the case of qualified pension plans and similar tax favored retirement arrangements) at $100 per day the failure continues, not to exceed $50,000. If any person fails to comply with a demand on the tax-exempt entity by the Secretary for disclosure, such person or persons shall pay a penalty of $100 per day (beginning on the date of the failure to comply) not to exceed $10,000 per prohibited tax shelter transaction. As under present-law section 6652, no

[109] The IRS Commissioner may rescind all or any portion of any such penalty if the violation is with respect to a prohibited tax shelter transaction other than a listed transaction and doing so would promote compliance with the requirements of the Code and effective tax administration. See sec. 6707A(d).

penalty is imposed with respect to any failure if it is shown that the failure is due to reasonable cause.

Penalty on entity managers

A tax of $20,000 is imposed on an entity manager that approves or otherwise causes a tax-exempt entity to be a party to a prohibited tax shelter transaction at any time during the taxable year, knowing or with reason to know that the transaction is a prohibited tax shelter transaction. An entity manager is defined as a person with authority or responsibility similar to that exercised by an officer, director, or trustee of an organization, except: (1) in the case of an entity described in section 501(c)(3) or (c)(4) (other than a private foundation), an entity manager is an organization manager as defined in section 4958(f)(2); and (2) in the case of a private foundation, an entity manager is a foundation manager as defined in section 4946(b). The reasonable cause (or no willful participation) exception applies to this tax.

Effective date.

The provision generally is effective for transactions after the date of enactment, except that no tax applies with respect to income that is properly allocable to any period on or before the date that is 90 days after the date of enactment. The disclosure provisions apply to disclosures the due date for which are after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement includes the Senate amendment provision, with modifications.

The conference agreement does not include the provision that the entity level or entity manager tax does not apply if the entity's participation is not willful and is due to reasonable cause.

In addition, the conference agreement adds a tax in the event that a tax-exempt entity becomes a party to a prohibited tax shelter transaction without knowing or having reason to know that the transaction is a prohibited tax shelter transaction. In that case, the tax-exempt entity is subject to a tax in the taxable year the entity becomes a party and any subsequent taxable year of the highest unrelated business taxable income rate times the greater of (1) the entity's net income (after taking into account any tax imposed with respect to the transaction) for such year that is attributable to the transaction or (2) 75 percent of the proceeds received by the entity that are attributable to the transaction for such year.[110]

The conference agreement clarifies that the entity level tax rate that applies if the entity knows or has reason to know that a transaction is a prohibited tax shelter transaction does not apply to subsequently listed transactions.

The conference agreement modifies the definition of an entity manager to provide that: (1) in the case of tax qualified pension plans, IRAs, and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and

[110] The conference agreement clarifies that in all cases the 75 percent of proceeds received by the entity that are attributable to the transaction are with respect to the taxable year.

qualified tuition plans) an entity manager is the person that approves or otherwise causes the entity to be a party to a prohibited tax shelter transaction, and (2) in all other cases the entity manager is the person with authority or responsibility similar to that exercised by an officer, director, or trustee of an organization, and with respect to any act, the person having authority or responsibility with respect to such act.

In the case of a qualified pension plan, IRA, or similar tax-favored savings arrangement (such as a Coverdell education savings account, health savings account, or qualified tuition plan), the conferees intend that, in general, a person who decides that assets of the plan, IRA, or other savings arrangement are to be invested in a prohibited tax shelter transaction is the entity manager under the provision. Except in the case of a fully self-directed plan or other savings arrangement with respect to which a participant or beneficiary decides to invest in the prohibited tax shelter transaction, a participant or beneficiary generally is not an entity manager under the provision. Thus, for example, a participant or beneficiary is not an entity manager merely by reason of choosing among pre-selected investment options (as is typically the case if a qualified retirement plan provides for participant-directed investments).[111] Similarly, if an individual has an IRA and may choose among various mutual funds offered by the IRA trustee, but has no control over the investments held in the mutual funds, the individual is not an entity manager under the provision.

Under the provision, certain taxes are imposed if the entity or entity manager knows or has reason to know that a transaction is a prohibited tax shelter transaction. In general, the conferees intend that in order for an entity or entity manager to have reason to know that a transaction is a prohibited tax shelter transaction, the entity or entity manager must have knowledge of sufficient facts that would lead a reasonable person to conclude that the transaction is a prohibited tax shelter transaction. If there is justifiable reliance on a reasoned written opinion of legal counsel (including in-house counsel) or of an independent accountant with expertise in tax matters, after making full disclosure of relevant facts about a transaction to such counsel or accountant, that a transaction is not a prohibited tax shelter transaction, then absent knowledge of facts not considered in the reasoned written opinion that would lead a reasonable person to conclude that the transaction is a prohibited tax shelter transaction, the reason to know standard is not met.

Not obtaining a reasoned written opinion of legal counsel does not alone indicate whether a person has reason to know. However, if a transaction is extraordinary for the entity, promises a return for the organization that is exceptional considering the amount invested by, the participation of, or the absence of risk to the organization, or the transaction is of significant size, either in an absolute sense or relative to the receipts of the entity, then, in general, the presence of such factors may indicate that the entity or entity manager has a responsibility to inquire further about whether a trans-

[111] Depending on the circumstances, the person who is responsible for determining the preselected investment options may be an entity manager under the provision.

action is a prohibited tax shelter transaction, or, absent such inquiry, that the reason to know standard is satisfied. For example, if a tax-exempt entity's investment in a transaction is $1,000, and the entity is promised or expects to receive $10,000 in the near term, in general, the rate of return would be considered exceptional and the entity should make inquiries with respect to the transaction. As another example, if a tax-exempt entity's expected income from a transaction is greater than five percent of the entity's annual receipts, or is in excess of $1,000,000, and the entity fails to make appropriate inquiries with respect to its participation in such transaction, such failure is a factor tending to show that the reason to know standard is met. Appropriate inquiries need not involve obtaining a reasoned written opinion. In general, if a transaction does not present the factors described above and the organization is small (measured by receipts and assets) and described in section 501(c)(3), it is expected that the reason to know standard will not be met.

In general, the conferees intend that in determining whether a tax-exempt entity is a "party" to a prohibited tax shelter transaction all the facts and circumstances should be taken into account. Absence of a written agreement is not determinative. Certain indirect involvement in a prohibited tax shelter transaction would not result in an entity being considered a party to the transaction. For example, investment by a tax-exempt entity in a mutual fund that in turn invests in or participates in a prohibited tax shelter transaction does not, in general, make the tax-exempt entity a party to such transaction, absent facts or circumstances that indicate that the purpose of the tax exempt entity's investment in the mutual fund was specifically to participate in such a transaction. However, whether a tax-exempt entity is a party to such a transaction will be informed by whether the entity or entity manager knew or had reason to know that an investment of the entity would be used in a prohibited tax shelter transaction. Presence of such knowledge or reason to know may indicate that the purpose of the investment was to participate in the prohibited tax shelter transaction and that the tax-exempt entity is a party to such transaction.

The conference agreement clarifies that a subsequently listed transaction means any transaction to which a tax-exempt entity is a party and which is determined by the Secretary to be a listed transaction at any time after the entity has "become a party to" the transaction, and not, as under the Senate amendment, when the entity "entered into" the transaction. The conference agreement provides that a subsequently listed transaction does not include a transaction that is a prohibited reportable transaction. The conference agreement provides that the Secretary has the authority to allocate proceeds as well as income of a tax-exempt entity to various periods. The conference agreement also provides that the disclosure by tax-exempt entities to the Internal Revenue Service required under the provision is based on an entity's being a party to a prohibited tax shelter transaction and not, as under the Senate amendment, on an entity's "participation" in a prohibited tax shelter transaction. The conference agreement further provides that the Secretary may make a demand for disclosure on any entity manager subject to the tax, as well as on any tax exempt entity, and

also provides that such managers and entities and not, as under the Senate amendment, "persons" are subject to the penalty for failure to comply with the demand.

Effective date.—In general, the provision is effective for taxable years ending after the date of enactment, with respect to transactions before, on, or after such date, except that no tax shall apply with respect to income or proceeds that are properly allocable to any period ending on or before the date that is 90 days after the date of enactment. The tax on certain knowing transactions does not apply to any prohibited tax shelter transaction to which a tax-exempt entity became a party on or before the date of enactment. The disclosure provisions apply to disclosures the due date for which are after the date of enactment.

2. Apply an excise tax to acquisitions of interests in insurance contracts in which certain exempt organizations hold interests (sec. 212 of the Senate amendment and new secs. 4966 and 6050V of the Code)

PRESENT LAW

Amounts received under a life insurance contract

Amounts received under a life insurance contract paid by reason of the death of the insured are not includible in gross income for Federal tax purposes.[112] No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract (inside buildup).[113]

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income to the extent that the amounts distributed exceed the taxpayer's investment in the contract (i.e., basis). Such distributions generally are treated first as a tax-free recovery of basis, and then as income.[114]

Transfers for value

A limitation on the exclusion for amounts received under a life insurance contract is provided in the case of transfers for value. If a life insurance contract (or an interest in the contract) is transferred for valuable consideration, the amount excluded from income by reason of the death of the insured is limited to the actual value of the consideration plus the premiums and other amounts subsequently paid by the acquiror of the contract.[115]

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[112] Sec. 101(a).

[113] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract. Sec. 7702.

[114] Sec. 72(e). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59½ and in certain other circumstances. Secs. 72(e) and (v). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums. Sec. 7702A.

[115] Section 101(a)(2). The transfer-for-value rule does not apply, however, in the case of a transfer in which the life insurance contract (or interest in the contract) transferred has a basis in the hands of the transferee that is determined by reference to the transferor's basis. Similarly, the transfer-for-value rule generally does not apply if the transfer is between certain parties (specifically, if the transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer).

Tax treatment of charitable organizations and donors

Present law generally provides tax-exempt status for charitable, educational and certain other organizations, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and which meet certain other requirements.[116] Governmental entities, including some educational organizations, are exempt from tax on income under other tax rules providing that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof.[117]

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity for exclusively public purposes.[118]

State-law insurable interest rules

State laws generally provide that the owner of a life insurance contract must have an insurable interest in the insured person when the life insurance contract is issued. State laws vary as to the insurable interest of a charitable organization in the life of any individual. Some State laws provide that a charitable organization meeting the requirements of section 501(c)(3) of the Code is treated as having an insurable interest in the life of any donor,[119] or, in other States, in the life of any individual who consents (whether or not the individual is a donor).[120] Other States' insurable interest rules permit the purchase of a life insurance contract even though the person paying the consideration has no insurable interest in the life of the person insured if a charitable, benevolent, educational or religious institution is designated irrevocably as the beneficiary.[121]

Transactions involving charities and non-charities acquiring life insurance

Recently, there has been an increase in transactions involving the acquisition of life insurance contracts using arrangements in which both exempt organizations, primarily charities, and private investors have an interest in the contract.[122] The exempt organization has an insurable interest in the insured individuals, either because they are donors, because they consent, or otherwise under applicable State insurable interest rules. Private investors provide capital used to fund the purchase of the life insurance contracts, sometimes together with annuity contracts. Both the private investors and the charity have an interest in the contracts, directly or

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[116] Section 501(c)(3).

[117] Section 115.

[118] Section 170.

[119] See, e.g., Mass. Gen. Laws Ann. ch. 175, sec. 123A(2) (West 2005); Iowa Code Ann. sec. 511.39 (West 2004) ("a person who, when purchasing a life insurance policy, makes a donation to the charitable organization or makes the charitable organization the beneficiary of all or a part of the proceeds of the policy . . .).

[120] See, e.g., Cal. Ins. Code sec. 10110.1(f) (West 2005); 40 Pa. Cons. Stat. Ann. sec. 40–512 (2004); Fla. Stat. Ann. sec. 27.404 (2) (2004); Mich. Comp. Laws Ann. sec. 500.2212 (West 2004).

[121] Or. Rev. Stat. sec. 743.030 (2003); Del. Code Ann. Tit. 18, sec. 2705(a) (2004).

[122] Davis, Wendy, "Death-Pool Donations," Trusts and Estates, May 2004, 55; Francis, Theo, "Tax May Thwart Investment Plans Enlisting Charities," Wall St. J., Feb. 8, 2005, A–10.

indirectly, through the use of trusts, partnerships, or other arrangements for sharing the rights to the contracts. Both the charity and the private investors receive cash amounts in connection with the investment in the contracts while the life insurance is in force or as the insured individuals die.

HOUSE BILL

No provision.

SENATE AMENDMENT

The provision imposes an excise tax, equal to 100 percent of the acquisition costs, on the taxable acquisition of any interest in an applicable insurance contract. An applicable insurance contract is any life insurance, annuity or endowment contract in which both an applicable exempt organization and any person that is not an applicable exempt organization have, directly or indirectly, held an interest in the contract (whether or not the interests are held at the same time).

An applicable exempt organization is any organization described in section 170(c), 168(h)(2)(A)(iv), 2055(a), or 2522(a). Thus, for example, an applicable exempt organization generally includes an organization that is exempt from Federal income tax by reason of being described in section 501(c)(3) (including one organized outside the United States), a government or political subdivision of a government, and an Indian tribal government.

A taxable acquisition is the acquisition of any direct or indirect interest in an applicable insurance contract by an applicable exempt organization, or by any other person if the interest in the contract in that person's hands is not described in the specific exceptions to "applicable insurance contract."

Under the provision, acquisition costs mean the direct or indirect costs (including premiums, commissions, fees, charges, or other amounts) of acquiring or maintaining an interest in an applicable insurance contract. Except as provided in regulations, if acquisition costs of any taxable acquisition are paid or incurred in more than one calendar year, the excise tax under the provision is imposed each time such costs are paid or incurred. In the case of an acquisition of an interest in an entity that directly or indirectly holds an interest in an applicable insurance contract, acquisition costs are intended to include the amount of money or value of property (including an applicable insurance contract) contributed to an entity or otherwise transferred or paid to acquire or increase an interest in the entity, that directly or indirectly holds an interest in an applicable insurance contract.

For example, acquisition costs include (1) each premium, commission, or fee with respect to the contract, (2) each amount paid or incurred to acquire or increase an interest in the contract, (3) each amount paid or incurred to acquire or increase an interest in an entity (such as a partnership, trust, corporation, or other type of entity or arrangement) that has a direct or indirect interest in the contract, and (4) if the contract is contributed to an entity, the greater of the value of the contract or the total amount of premiums, commissions, and fees paid or incurred to acquire and maintain the insurance contract. It is intended that, under regu-

latory authority provided as necessary to carry out the purposes of the provision, any other similar or economically equivalent amount paid or incurred is to be treated as acquisition costs.

Under the provision, an interest in an applicable insurance contract includes any right with respect to the contract, whether as an owner, beneficiary, or otherwise. An indirect interest in a contract includes an interest in an entity that, directly or indirectly, holds an interest in the contract. In the case of a section 1035 exchange of an applicable insurance contract, any interest in any of the contracts involved in the exchange is treated as an interest in all such contracts. An increase in an interest in an applicable insurance contract is treated as a separate acquisition, for purposes of application of the excise tax under the provision.

If an interest of an applicable exempt organization exists solely because the organization holds, as part of a diversified investment strategy, a de minimis interest in an entity which directly or indirectly holds an interest in the contract, such interest is not taken into account for purposes of the provision. For example, if an applicable exempt organization owns a de minimis amount of stock in a corporation which in turn owns life insurance contracts covering key employees, the excise tax under the provision does not apply because the stock ownership is not treated as an indirect interest in this circumstance. It is intended that Treasury regulations provide guidance as to the application of this rule so that it does not permit circumvention of the provision.

Except as provided in regulations, if a person acquires an interest in a contract before the contract is treated as an applicable insurance contract, the acquisition is treated as a taxable acquisition of an interest in applicable insurance contract as of the date the contract becomes an applicable insurance contract.

It is intended that an interest in an applicable insurance contract includes, for example, (1) a right with respect to the applicable insurance contract pursuant to a side contract or other similar arrangement, (2) an interest as a trust beneficiary in distributions from or income of a trust holding an interest in a contract, and (3) a right to distributions, guaranteed payments, or income of a partnership that holds an interest in a contract. It is not intended that a right with respect to the contract include typical rights of issuers of applicable insurance contracts.

Exceptions to the term "applicable insurance contract" apply under the provision. First, the term does not apply if each person (other than an applicable exempt organization) with a direct or indirect interest in the contract has an insurable interest in the insured independent of any interest of the exempt organization in the contract. Second, the term does not apply if the sole interest in the contract of each person other than the applicable exempt organization is as a named beneficiary. Third, the term does not apply if the sole interest in the contract of each person other than the applicable exempt organization is either (1) as a beneficiary of a trust holding an interest in the contract, but only if the person's designation as such a beneficiary was made without consideration and solely on a purely gratuitous basis, or (2) as a trustee who holds an interest in the contract in a fiduciary capacity solely for the ben-

efit of applicable exempt organizations or of persons otherwise meeting one of the first two exceptions.

An exception to the term "applicable insurance contract" also is provided under the provision in certain cases in which a person other than an applicable exempt organization has an interest solely as a lender[123] with respect to the contract, and the contract covers only one individual who is an officer, director, or employee of the applicable exempt organization with an interest in the contract, provided other requirements are met. This exception applies only if the number of insured persons under loans by such lenders with respect to such contracts does not exceed the greater of: (1) the lesser of five percent of the total officers, directors, and employees of the organization or 20, or (2) five. Under this exception, the aggregate amount of indebtedness with respect to 1 or more contracts covering a single individual may not exceed $50,000.

In addition, Treasury regulatory authority is provided to except certain contracts from treatment as applicable insurance contracts. Contracts may be excepted based on specific factors including (1) whether the transaction is at arms' length, (2) whether the economic benefits to the applicable exempt organization substantially exceed the economic benefits to all other persons with an interest in the contract (determined without regard to whether, or the extent to which, such organization has paid or contributed with respect to the contract), and (3) the likelihood of abuse.

The application of the exceptions can be illustrated as follows. Assume that an individual acquires a life insurance contract in which the individual is the insured person, and the named beneficiaries are the individual's son and a university that is an organization described in section 170(c). The contract is not an applicable insurance contract because the first exception applies. That is, because both the individual and his son have an insurable interest in the individual, all persons holding any interest in the contract (other than applicable exempt organizations) have an insurable interest in the insured independent of any interest of an applicable exempt organization in the contract. The second exception also applies in this situation.

As another example, assume that the three named beneficiaries are the insured's son, an unrelated friend, and a charity. The contract is not an applicable insurance contract because the second exception applies. That is, each beneficiary's sole interest is as a named beneficiary. In addition, the first exception also applies in this situation.

As a further example, assume that the insured individual creates an irrevocable trust for the benefit of the insured's descendants, and that the trustee of the trust uses trust funds to purchase a life insurance policy on the insured's life, and the trust is both the owner and beneficiary of the insurance policy. The insured individual's naming of his or her descendants as trust beneficiaries is a gratuitous act, done without consideration. As a result, the contract is not an applicable insurance contract under the third exception.

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[123] For this purpose, an interest as a lender includes a security interest in the insurance contract to which the loan relates.

No Federal income tax deduction is permitted for the excise tax payable under the provision, as provided under the rule of Code section 275(a)(6). The amount of the excise tax payable under the provision is not included in the investment in the contract for purposes of section 72.

Treasury regulatory authority is provided to carry out the purposes of the provision. This includes authority to provide appropriate rules in the case in which a person acquires an interest before a contract is treated as an applicable insurance contract. This also includes authority to prevent, in cases the Treasury Secretary determines appropriate, the imposition of more than one tax if the same interest is acquired more than once (otherwise, the tax under the provision applies to each acquisition). Treasury regulatory authority is also provided to prevent avoidance of the provision, including through the use of intermediaries.

The provision provides reporting rules requiring an applicable exempt organization or other person that makes a taxable acquisition of an applicable insurance contract to file a return containing required information and such other information as is prescribed by the Treasury Secretary. Under these rules, a statement is required to be furnished to each person whose taxpayer identification information is required to be reported on the return. Penalties apply for failure to file the return or furnish the statement, including, in the case of intentional disregard of the return filing requirement, a penalty equal to the amount of the excise tax that has not been paid with respect to the items required to be included on the return.

Effective date.—The provision is effective for contracts issued after May 3, 2005.

The application of the effective date with respect to prior acquisitions of interests may be illustrated as follows. Assume that an exempt organization and a person that is not an exempt organization described in section 170(c) form a partnership before May 3, 2005. After May 3, 2005, the partnership acquires an interest in a life insurance contract that is issued after May 3, 2005. The acquisition by the partnership of the interest in the contract is treated as a taxable acquisition under the provision by each of the partners (*i.e.*, the exempt organization and the other person).

The provision also requires reporting of existing life insurance, endowment and annuity contracts issued on or before that date, in which an applicable exempt organization holds an interest on that date and which would be treated as an applicable insurance contract under the provision. This reporting is required within one year after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

3. Increase the amounts of excise taxes imposed on public charities, social welfare organizations, and private foundations (sec. 213 of the Senate amendment and secs. 4941, 4942, 4943, 4944, 4945, and 4958 of the Code)

PRESENT LAW

Public charities and social welfare organizations

The Code imposes excise taxes on excess benefit transactions between disqualified persons (as defined in section 4958(f)) and charitable organizations (other than private foundations) or social welfare organizations (as described in section 501(c)(4)).[124] An excess benefit transaction generally is a transaction in which an economic benefit is provided by a charitable or social welfare organization directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

The excess benefit tax is imposed on the disqualified person and, in certain cases, on the organization manager, but is not imposed on the exempt organization. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected. A tax of 10 percent of the excess benefit (not to exceed $10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.[125] If more than one person is liable for the tax on disqualified persons or on management, all such persons are jointly and severally liable for the tax.[126]

Private foundations

Self-dealing by private foundations

Excise taxes are imposed on acts of self-dealing between a disqualified person (as defined in section 4946) and a private foundation.[127] In general, self-dealing transactions are any direct or indirect: (1) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (2) lending of money or other extension of credit between a private foundation and a disqualified person; (3) the furnishing of goods, services, or facilities between a private foundation and a disqualified person; (4) the payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; (5) the transfer to, or use by or for the benefit of, a disqualified person of the income or as-

[124] Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status.

[125] Sec. 4958(d)(2). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[126] Sec. 4958(d)(1).

[127] Sec. 4941.

sets of the private foundation; and (6) certain payments of money or property to a government official.[128] Certain exceptions apply.[129]

An initial tax of five percent of the amount involved with respect to an act of self-dealing is imposed on any disqualified person (other than a foundation manager acting only as such) who participates in the act of self-dealing. If such a tax is imposed, a 2.5-percent tax of the amount involved is imposed on a foundation manager who participated in the act of self-dealing knowing it was such an act (and such participation was not willful and was due to reasonable cause) up to $10,000 per act. Such initial taxes may not be abated.[130] Such initial taxes are imposed for each year in the taxable period, which begins on the date the act of self-dealing occurs and ends on the earliest of the date of mailing of a notice of deficiency for the tax, the date on which the tax is assessed, or the date on which correction of the act of self-dealing is completed. A government official (as defined in section 4946(c)) is subject to such initial tax only if the official participates in the act of self-dealing knowing it is such an act. If the act of self-dealing is not corrected, a tax of 200 percent of the amount involved is imposed on the disqualified person and a tax of 50 percent of the amount involved (up to $10,000 per act) is imposed on a foundation manager who refused to agree to correcting the act of self-dealing. Such additional taxes are subject to abatement.[131]

Tax on failure to distribute income

Private nonoperating foundations are required to pay out a minimum amount each year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization's exempt purposes, including reasonable and necessary administrative expenses.[132] Failure to pay out the minimum results in an initial excise tax on the foundation of 15 percent of the undistributed amount. An additional tax of 100 percent of the undistributed amount applies if an initial tax is imposed and the required distributions have not been made by the end of the applicable taxable period.[133] A foundation may include as a qualifying distribution the salaries, occupancy expenses, travel costs, and other reasonable and necessary administrative expenses that the foundation incurs in operating a grant program. A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's exempt purposes and certain amounts set-aside for exempt purposes.[134] Private operating foundations are not subject to the payout requirements.

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[128] Sec. 4941(d)(1).
[129] See sec. 4941(d)(2).
[130] Sec. 4962(b).
[131] Sec. 4961.
[132] Sec. 4942(g)(1)(A).
[133] Sec. 4942(a) and (b). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.
[134] Sec. 4942(g)(1)(B) and 4942(g)(2). In general, an organization is permitted to adjust the distributable amount in those cases where distributions during the five preceding years have exceeded the payout requirements. Sec. 4942(i).

Tax on excess business holdings

Private foundations are subject to tax on excess business holdings.[135] In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership ("profits interest" is substituted for "voting stock" and "capital interest" for "nonvoting stock") and to other unincorporated enterprises (by substituting "beneficial interest" for "voting stock"). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.[136] This five-year period may be extended an additional five years in limited circumstances.[137]

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation's applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

Tax on jeopardizing investments

Private foundations and foundation managers are subject to tax on investments that jeopardize the foundation's charitable purpose.[138] In general, an initial tax of five percent of the amount of the investment applies to the foundation and to foundation managers who participated in the making of the investment knowing that it jeopardized the carrying out of the foundation's exempt purposes. The initial tax on foundation managers may not exceed $5,000 per investment. If the investment is not removed from jeopardy (e.g., sold or otherwise disposed of), an additional tax of 25 percent of the amount of the investment is imposed on the foundation and five percent of the amount of the investment on a foundation manager who refused to agree to removing the investment from jeopardy. The additional tax on foundation managers may not exceed $10,000 per investment. An investment, the primary purpose of which is to accomplish a charitable purpose and no significant purpose of which is the production of income or the appreciation of property, is not considered a jeopardizing investment.[139]

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[135] Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.
[136] Sec. 4943(c)(6).
[137] Sec. 4943(c)(7).
[138] Sec. 4944. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.
[139] Sec. 4944(c).

Tax on taxable expenditures

Certain expenditures of private foundations are subject to tax.[140] In general, taxable expenditures are expenses: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility[141] with respect to the grant; or (5) for any non-charitable purpose. For each taxable expenditure, a tax is imposed on the foundation of 10 percent of the amount of the expenditure, and an additional tax of 100 percent is imposed on the foundation if the expenditure is not corrected. A tax of 2.5 percent of the expenditure (up to $5,000) also is imposed on a foundation manager who agrees to making a taxable expenditure knowing that it is a taxable expenditure. An additional tax of 50 percent of the amount of the expenditure (up to $10,000) is imposed on a foundation manager who refuses to agree to correction of such expenditure.

HOUSE BILL

No provision.

SENATE AMENDMENT

Self-dealing and excess benefit transaction initial taxes and dollar limitations

For acts of self-dealing other than the payment of compensation by a private foundation to a disqualified person, the provision increases the initial tax on the self-dealer from five percent of the amount involved to 10 percent of the amount involved. For acts of self-dealing regarding the payment of compensation by a private foundation to a disqualified person, the provision increases the initial tax on the self-dealer from five percent of the amount involved (none of which is subject to abatement) to 25 percent of the amount involved (15 percent of which is subject to abatement). The provision increases the initial tax on foundation managers from 2.5 percent of the amount involved to five percent of the amount involved and increases the dollar limitation on the amount of the initial and additional taxes on foundation managers per act of self-dealing from $10,000 per act to $20,000 per act. Similarly, the provision doubles the dollar limitation on organization managers of public charities and social welfare organizations for participation in excess benefit transactions from $10,000 per transaction to $20,000 per transaction.

[140] Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[141] In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

Failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures

The provision doubles the amounts of the initial taxes and the dollar limitations on foundation managers with respect to the private foundation excise taxes on the failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures.

Specifically, for the failure to distribute income, the initial tax on the foundation is increased from 15 percent of the undistributed amount to 30 percent of the undistributed amount.

For excess business holdings, the initial tax on excess business holdings is increased from five percent of the value of such holdings to 10 percent of such value.

For jeopardizing investments, the initial tax of five percent of the amount of the investment that is imposed on the foundation and on foundation managers is increased to 10 percent of the amount of the investment. The dollar limitation on the initial tax on foundation managers of $5,000 per investment is increased to $10,000 and the dollar limitation on the additional tax on foundation managers of $10,000 per investment is increased to $20,000.

For taxable expenditures, the initial tax on the foundation is increased from 10 percent of the amount of the expenditure to 20 percent, the initial tax on the foundation manager is increased from 2.5 percent of the amount of the expenditure to five percent, the dollar limitation on the initial tax on foundation managers is increased from $5,000 to $10,000, and the dollar limitation on the additional tax on foundation managers is increased from $10,000 to $20,000.

Effective date

The provision is effective for taxable years beginning after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

4. Reform rules for charitable contributions of easements on buildings in registered historic districts (sec. 214 of the Senate amendment and sec. 170 of the Code)

PRESENT LAW

In general

Present law provides special rules that apply to charitable deductions of qualified conservation contributions, which include conservation easements and facade easements.[142] Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property.[143] Accordingly, qualified conservation

[142] Sec. 170(h).
[143] Sec. 170(f)(3).

contributions are contributions of partial interests that are eligible for a fair market value charitable deduction.

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property.[144] Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations.

Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.[145]

In general, no deduction is available if the property may be put to a use that is inconsistent with the conservation purpose of the gift.[146] A contribution is not deductible if it accomplishes a permitted conservation purpose while also destroying other significant conservation interests.[147]

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach an appraisal summary to the tax return.[148] Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[149] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[150]

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[144] Charitable contributions of interests that constitute the taxpayer's entire interest in the property are not regarded as qualified real property interests within the meaning of section 170(h), but instead are subject to the general rules applicable to charitable contributions of entire interests of the taxpayer (i.e., generally are deductible at fair market value, without regard to satisfaction of the requirements of section 170(h)).

[145] Sec. 170(h)(4)(A).

[146] Treas. Reg. sec. 1.170A–14(e)(2).

[147] Treas. Reg. sec. 1.170A–14(e)(2).

[148] Sec. 170(f)(11)(C).

[149] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[150] Treas. Reg. sec. 1.170A–13(c)(3).

Valuation

The value of a conservation restriction granted in perpetuity generally is determined under the "before and after approach." Such approach provides that the fair market value of the restriction is equal to the difference (if any) between the fair market value of the property the restriction encumbers before the restriction is granted and the fair market value of the encumbered property after the restriction is granted.[151]

If the granting of a perpetual restriction has the effect of increasing the value of any other property owned by the donor or a related person, the amount of the charitable deduction for the conservation contribution is to be reduced by the amount of the increase in the value of the other property.[152] In addition, the donor is to reduce the amount of the charitable deduction by the amount of financial or economic benefits that the donor or a related person receives or can reasonably be expected to receive as a result of the contribution.[153] If such benefits are greater than those that will inure to the general public from the transfer, no deduction is allowed.[154] In those instances where the grant of a conservation restriction has no material effect on the value of the property, or serves to enhance, rather than reduce, the value of the property, no deduction is allowed.[155]

Preservation of a certified historic structure

A certified historic structure means any building, structure, or land which is (i) listed in the National Register, or (ii) located in a registered historic district (as defined in section 47(c)(3)(B)) and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.[156] For this purpose, a structure means any structure, whether or not it is depreciable, and, accordingly, easements on private residences may qualify.[157] If restrictions to preserve a building or land area within a registered historic district permit future development on the site, a deduction will be allowed only if the terms of the restrictions require that such development conform with appropriate local, State, or Federal standards for construction or rehabilitation within the district.[158]

The IRS and the courts have held that a facade easement may constitute a qualifying conservation contribution.[159] In general, a facade easement is a restriction the purpose of which is to preserve certain architectural, historic, and cultural features of the facade, or front, of a building. The terms of a facade easement might permit the property owner to make alterations to the facade of the

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[151] Treas. Reg. sec. 1.170A–14(h)(3).
[152] Treas. Reg. sec. 1.170A–14(h)(3)(i).
[153] Id.
[154] Id.
[155] Treas. Reg. sec. 1.170A–14(h)(3)(ii).
[156] Sec. 170(h)(4)(B).
[157] Treas. Reg. sec. 1.170A–14(d)(5)(iii).
[158] Treas. Reg. sec. 1.170A–14(d)(5)(i).
[159] *Hillborn* v. *Commissioner,* 85 T.C. 677 (1985) (holding the fair market value of a facade donation generally is determined by applying the "before and after" valuation approach); *Richmond* v. *U.S.,* 699 F. Supp. 578 (E.D. La. 1988); Priv. Ltr. Rul. 199933029 (May 24, 1999) (ruling that a preservation and conservation easement relating to the facade and certain interior portions of a fraternity house was a qualified conservation contribution).

structure if the owner obtains consent from the qualified organization that holds the easement.

HOUSE BILL

No provision.

SENATE AMENDMENT

The provision revises the rules for qualified conservation contributions with respect to property for which a charitable deduction is allowable under section 170(h)(4)(B)(ii) by reason of a property's location in a registered historic district. Under the provision, a charitable deduction is not allowable with respect to a structure or land area located in such a district (by reason of the structure or land area's location in such a district). A charitable deduction is allowable with respect to buildings (as is the case under present law) but the qualified real property interest that relates to the exterior of the building must preserve the entire exterior of the building, including the space above the building, the sides, the rear, and the front of the building. In addition, such qualified real property interest must provide that no portion of the exterior of the building may be changed in a manner inconsistent with the historical character of such exterior.

For any contribution relating to a registered historic district made after the date of enactment of the provision, taxpayers must include with the return for the taxable year of the contribution a qualified appraisal of the qualified real property interest (irrespective of the claimed value of such interest) and attach the appraisal with the taxpayer's return, photographs of the entire exterior of the building, and descriptions of all current restrictions on development of the building, including, for example, zoning laws, ordinances, neighborhood association rules, restrictive covenants, and other similar restrictions. Failure to obtain and attach an appraisal or to include the required information results in disallowance of the deduction. In addition, the donor and the donee must enter into a written agreement certifying, under penalty of perjury, that the donee is a qualified organization, with a purpose of environmental protection, land conservation, open space preservation, or historic preservation, and that the donee has the resources to manage and enforce the restriction and a commitment to do so.

Taxpayers claiming a deduction for a qualified conservation contribution with respect to the exterior of a building located in a registered historic district in excess of the greater of three percent of the fair market value of the underlying property or $10,000 must pay a $500 fee to the Internal Revenue Service or the deduction is not allowed. Amounts paid are required to be dedicated to Internal Revenue Service enforcement of qualified conservation contributions.

Effective date.—The provision relating to deductions for contributions relating to structures and land areas is effective for contributions made after the date of enactment. The limitation on the amount that may be deducted and the filing fee is effective for contributions made 180 days after the date of enactment. The rest of the provision is effective for contributions made after November 15, 2005.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

5. Reform rules relating to charitable contributions of taxidermy and recapture tax benefit on property not used for an exempt use (secs. 215 and 216 of the Senate amendment and secs. 170, 6050L, and new sec. 6720B of the Code)

PRESENT LAW

Deductibility of charitable contributions

In general

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity.[160] The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[161] In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor,[162] though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

Contributions of property

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. Capital gain property means any capital asset, or property used in the taxpayer's trade or business, the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations (*i.e.*, limitations based on the donor's income) than other contributions of property.

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, *e.g.*, property that, at the time of contribu-

[160] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

[161] Secs. 170(b) and (e).

[162] Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

tion, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;[163] (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of taxidermy are subject to the tangible personal property rule (number (2) above). For example, for appreciated taxidermy, if the property is used to further the donee's exempt purpose, the deduction is fair market value. But if the property is not used to further the donee's exempt purpose, the deduction is the donor's basis. If the taxidermy is depreciated, i.e., the value is less than the taxpayer's basis in such property, taxpayers generally deduct the fair market value of such contributions, regardless of whether the property is used for exempt or unrelated purposes by the donee.

Substantiation

No charitable deduction is allowed for any contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization.[164] Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution (and a good faith estimate of the value of any such goods or services).

In general, if the total charitable deduction claimed for noncash property is more than $500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.[165] C corporations (other than personal service corporations and closely-held corporations) are required to file Form 8283 only if the deduction claimed is more than $5,000. Information required on the Form 8283 includes, among other things, a description of the property, the appraised fair market value (if an appraisal is required), the donor's basis in the property, how the donor acquired the property, a declaration by the appraiser regarding the appraiser's general qualifications, an acknowledgement by the donee that it is eligible to receive deductible contributions, and an indication by the donee whether the property is intended for an unrelated use.

Taxpayers are required to obtain a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.[166] Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under sec-

[163] For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (*i.e.*, basis plus one half of fair market value in excess of basis) or (2) two times basis. Sec. 170(e)(3), 170(e)(4), 170(e)(6).

[164] Sec. 170(f)(8).

[165] Sec. 170(f)(11).

[166] Id.

tion 170;[167] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[168] In the case of contributions of art valued at more than $20,000 and other contributions of more than $500,000, taxpayers are required to attach the appraisal to the tax return. Taxpayers may request a Statement of Value from the Internal Revenue Service in order to substantiate the value of art with an appraised value of $50,000 or more for income, estate, or gift tax purposes.[169] The fee for such a Statement is $2,500 for one, two, or three items or art plus $250 for each additional item.

If a donee organization sells, exchanges, or otherwise disposes of contributed property with a claimed value of more than $5,000 (other than publicly traded securities) within two years of the property's receipt, the donee is required to file a return (Form 8282) with the Secretary, and to furnish a copy of the return to the donor, showing the name, address, and taxpayer identification number of the donor, a description of the property, the date of the contribution, the amount received on the disposition, and the date of the disposition.[170]

HOUSE BILL

No provision.

SENATE AMENDMENT

Contributions of taxidermy

For contributions of taxidermy property with a claimed value of more than $500, the individual must include with the individual's return a photograph of the taxidermy and comparable sales data for similar items. It is intended that valuation must be based on comparable sales and that a deduction is not allowable if sufficient comparable sales are not provided.

For claims of more than $5,000, the taxpayer must notify the IRS of the deduction and include with the taxpayer's return a statement of value from the IRS, similar to that available under present law for items of art, or a request for such a statement and a fee of $500. The provision defines taxidermy property as a mounted work of art which contains any part of a dead animal.

It is intended that for purposes of the charitable contribution deduction, a taxpayer may not include in the taxpayer's basis of the contributed taxidermy any costs attributable to travel.

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[167] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[168] Treas. Reg. sec. 1.170A–13(c)(3). Sec. 170(f)(11)(E).

[169] Rev. Proc. 96–15, 1996–1 C.B. 627.

[170] Sec. 6050L(a)(1).

Recapture of tax benefit upon subsequent disposition of tangible personal property intended for an exempt use

In general, the provision recovers the tax benefit for charitable contributions of tangible personal property with respect to which a fair market value deduction is claimed and which is not used for exempt purposes. The provision applies to appreciated tangible personal property that is identified by the donee organization as for a use related to the purpose or function constituting the donee's basis for tax exemption, and for which a deduction of more than $5,000 is claimed ("applicable property").[171]

Under the provision, if a donee organization disposes of applicable property within three years of the contribution of the property, the donor is subject to an adjustment of the tax benefit. If the disposition occurs in the tax year of the donor in which the contribution is made, the donor's deduction generally is basis and not fair market value.[172] If the disposition occurs in a subsequent year, the donor must include as ordinary income for its taxable year in which the disposition occurs an amount equal to the excess (if any) of (i) the amount of the deduction previously claimed by the donor as a charitable contribution with respect to such property, over (ii) the donor's basis in such property at the time of the contribution.

There is no adjustment of the tax benefit if the donee organization makes a certification to the Secretary, by written statement signed under penalties of perjury by an officer of the organization. The statement must either (1) certify that the use of the property by the donee was related to the purpose or function constituting the basis for the donee's exemption, and describe how the property was used and how such use furthered such purpose or function; or (2) state the intended use of the property by the donee at the time of the contribution and certify that such use became impossible or infeasible to implement. The organization must furnish a copy of the certification to the donor.

A penalty of $10,000 applies to a person that identifies applicable property as having a use that is related to a purpose or function constituting the basis for the donee's exemption knowing that it is not intended for such a use.[173]

Reporting of exempt use property contributions

The provision modifies the present-law information return requirements that apply upon the disposition of contributed property by a charitable organization (Form 8282, sec. 6050L). The return requirement is extended to dispositions made within three years after receipt (from two years). The donee organization also must provide, in addition to the information already required to be provided on the return, a description of the donee's use of the property, a statement of whether use of the property was related to the purpose or function constituting the basis for the donee's exemption, and, if applicable, a certification of any such use (described above).

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[171] Present law rules continue to apply to any contribution of exempt use property for which a deduction of $5,000 or less is claimed.

[172] The disposition proceeds are regarded as relevant to a determination of fair market value.

[173] Other present-law penalties also may apply, such as the penalty for aiding and abetting the understatement of tax liability under section 6701.

Effective date

With respect to contributions of taxidermy property, the provision is effective for contributions made after November 15, 2005. With respect to exempt use property generally, the provision is effective for contributions made and returns filed after June 1, 2006.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

6. Limit charitable deduction for contributions of clothing and household items and modify recordkeeping and substantiation requirements for certain charitable contributions (secs. 217 and 218 of the Senate amendment and sec. 170 of the Code)

PRESENT LAW

Deductibility of charitable contributions

In general

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity.[174] The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[175] In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor,[176] though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

Contributions of property

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property.

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[174] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

[175] Secs. 170(b) and (e).

[176] Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;[177] (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of clothing and household items are subject to the tangible personal property rule (number (2) above). If such contributed property is appreciated property in the hands of the taxpayer, and is not used to further the donee's exempt purpose, the deduction is basis. In general, however, the value of clothing and household items is less than the taxpayer's basis in such property, with the result that taxpayers generally deduct the fair market value of such contributions, regardless of whether the property is used for exempt or unrelated purposes by the donee.

Substantiation

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution. For a contribution of money, the donor generally must maintain one of the following: (1) a cancelled check; (2) a receipt (or a letter or other written communication) from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution; or (3) in the absence of a cancelled check or a receipt, other reliable written records showing the name of the donee, the date of the contribution, and the amount of the contribution. For a contribution of property other than money, the donor generally must maintain a receipt from the donee organization showing the name of the donee, the date and location of the contribution, and a detailed description (but not the value) of the property.[178] A donor of property other than money need not obtain a receipt, however, if circumstances make obtaining a receipt impracticable. Under such circumstances, the donor must maintain reliable written records regarding the contribution. The required content of such a record varies depending upon factors such as the type and value of property contributed.[179]

In addition to the foregoing recordkeeping requirements, substantiation requirements apply in the case of charitable contributions with a value of $250 or more. No charitable deduction is allowed for any contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization. Such acknowledgement must include the amount of cash and a descrip-

[177] For certain contributions of inventory and other property, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. Sec. 170(e)(3), 170(e)(4), 170(e)(6).

[178] Treas. Reg. sec. 1.170A–13(a).

[179] Treas. Reg. sec. 1.170A–13(b).

tion (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such goods or services.[180] In general, if the total charitable deduction claimed for non-cash property is more than $500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.[181] In general, taxpayers are required to obtain a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.

HOUSE BILL

No provision.

SENATE AMENDMENT

General rule relating to clothing and household items

The provision requires the Secretary to prepare and publish an itemized list of clothing and household items and to assign an amount to each item on the list. The assigned amount is treated as the fair market value of the item for purposes of the charitable contribution deduction and is based on an assumption that the item is in good used condition or better. Any deduction for a charitable contribution of each such item may not exceed the item's assigned amount. Any deduction for an item not in good used condition or better may not exceed 20 percent of the item's assigned amount. Any deduction for an item that is not functional with respect to the use for which it was designed is not allowed. The list must be published by the Secretary at least once each calendar year and is applicable to contributions of clothing and household items made while the list is effective. The Secretary has discretion to determine the effective dates for each published list. The list should be prepared in consultation with donee organizations that accept charitable contributions of clothing and household items. In assigning amounts to particular items, the Secretary should take into account the sales price of such contributed item when sold by the donee organizations, whether through an exempt program of such organizations or otherwise. If an item of clothing or household item is not included on the list published by the Secretary, present law rules apply to the contribution of the item.

The provision does not apply to contributions for which the donor has obtained a qualified appraisal. The provision also does not apply to contributions for which a deduction of more than $500 is claimed if (1) the donee sells the contributed item before the earlier of the due date (including extensions) for filing the return of tax for the taxable year of the donor in which the contribution was made or the date such return was filed; (2) the donee reports the sales price of the contributed item to the donor; and (3) the amount claimed as a deduction with respect to the contributed item does not exceed the amount of the sales price reported to the donor.

The provision does not apply to contributions by C corporations. The provision applies to new and used items. Household

[180] Sec. 170(f)(8).
[181] Sec. 170(f)(11).

items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, and other objects of art, jewelry and gems, and collections are excluded from the provision.

Substantiation

Clothing and household items

As under present law, for contributions with a claimed value of $250 or more, the taxpayer must obtain contemporaneous substantiation from the donee organization, which must include a description of the property contributed. The provision provides that, as part of such substantiation, the taxpayer obtain an indication of the condition of the item(s), a description of the type of item, and either a copy of the published list or instructions as to how to find such list.

Under present law, if a taxpayer claims that the total value of charitable contributions of noncash property is more than $500, the taxpayer must include with the taxpayer's return a description of the property contributed and such other information as the Secretary may require in order to claim a charitable deduction (sec. 170(f)(11)(B)). This requirement presently is satisfied through completion by the taxpayer of the Form 8283 and attachment of the form to the taxpayer's return. The provision requires that the donor include the information about the contribution that is contained in the contemporaneous substantiation obtained from the donee organization (for gifts of $250 or more) as part of such requirement.

Contributions of cash

In addition, in the case of a charitable contribution of money, regardless of the amount, applicable recordkeeping requirements are satisfied under the provision only if the donor maintains a cancelled check or a receipt (or a letter or other written communication) from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. The recordkeeping requirements may not be satisfied by maintaining other written records.

Effective date

The provision relating to clothing and household items is effective for contributions made after December 31, 2006. The provision relating to substantiation more generally is effective for contributions made in taxable years beginning after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

7. Contributions of fractional interests in tangible personal property (sec. 219 of the Senate amendment and sec. 170 of the Code)

PRESENT LAW

In general, a charitable deduction is not allowable for a contribution of a partial interest in property, such as an income interest, a remainder interest, or a right to use property.[182] A gift of an undivided portion of a donor's entire interest in property generally is not treated as a nondeductible gift of a partial interest in property.[183] For this purpose, an undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property.[184] A gift generally is treated as a gift of an undivided portion of a donor's entire interest in property if the donee is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property.[185]

Consistent with these requirements, a charitable contribution deduction generally is not allowable for a contribution of a future interest in tangible personal property.[186] For this purpose, a future interest is one "in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization which has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property."[187] Treasury regulations provide that section 170(a)(3), which generally denies a deduction for a contribution of a future interest in tangible personal property, "[has] no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during three months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than one year."[188]

HOUSE BILL

No provision.

SENATE AMENDMENT

Require consistent valuation of fractional interests in the same item of property

In general, under present law and the provision a donor may take a deduction for a charitable contribution of a fractional inter-

[182] Secs. 170(f)(3)(A) (income tax), 2055(e)(2) (estate tax), and 2522(c)(2) (gift tax).
[183] Sec. 170(f)(3)(B)(ii).
[184] Treas. Reg. sec. 1.170A–7(b)(1).
[185] Treas. Reg. sec. 1.170A–7(b)(1).
[186] Sec. 170(a)(3).
[187] Treas. Reg. sec. 1.170A–5(a)(4).
[188] Treas. Reg. sec. 1.170A–5(a)(2).

est in tangible personal property (such as an artwork), provided the donor satisfies the requirements for deductibility (including the requirements concerning contributions of partial interests and future interests in property), and in subsequent years make additional charitable contributions of interests in the same property.[189] Under the provision, a donor's charitable deduction for the initial contribution of a fractional interest in an item of tangible personal property (or collection of such items) shall be determined as under current law (e.g., based upon the fair market value of the artwork at the time of the contribution of the fractional interest and considering whether the use of the artwork will be related to the donee's exempt purposes). For purposes of determining the deductible amount of each additional contribution of an interest (whether or not a fractional interest) in the same item of property, under the provision, the fair market value of the item shall be the lesser of: (1) the value used for purposes of determining the charitable deduction for the initial fractional contribution; or (2) the fair market value of the item at the time of the subsequent contribution. This portion of the provision applies for income, gift, and estate tax purposes.

Require actual possession by the donee

The provision provides for recapture of the income tax charitable deduction or gift tax charitable deduction under certain circumstances. Specifically, if, during any one-year period following a contribution of a fractional interest in an item of tangible personal property, the donee fails to take actual possession of the item for a period of time corresponding substantially to the donee's then-existing percentage interest in the item, then the donee's charitable deduction for all previous contributions of interests in the item shall be recaptured (plus interest).

Under the provision, the Secretary of the Treasury is authorized to promulgate rules to prevent the circumvention of the provision by, for example, engaging in a transaction in which a donor first transfers one or more items of tangible personal property to a separate entity in exchange for ownership interests in the entity, and subsequently makes charitable contributions of such ownership interests.

Effective date

The provision is applicable for contributions, bequests, and gifts made after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

[189] See, e.g., *Winokur* v. *Commissioner,* 90 T.C. 733 (1988).

8. Provisions relating to substantial and gross overstatement of valuations of property (sec. 220 of the Senate amendment and secs. 6662 and 6664 of the Code)

PRESENT LAW

Taxpayer penalties

Present law imposes accuracy-related penalties on a taxpayer in cases involving a substantial valuation misstatement or gross valuation misstatement relating to an underpayment of income tax.[190] For this purpose, a substantial valuation misstatement generally means a value claimed that is at least twice (200 percent or more) the amount determined to be the correct value, and a gross valuation misstatement generally means a value claimed that is at least four times (400 percent or more) the amount determined to be the correct value.

The penalty is 20 percent of the underpayment of tax resulting from a substantial valuation misstatement and rises to 40 percent for a gross valuation misstatement. No penalty is imposed unless the portion of the underpayment attributable to the valuation misstatement exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). Under present law, no penalty is imposed with respect to any portion of the understatement attributable to any item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return and there is a reasonable basis for the tax treatment. Special rules apply to tax shelters.

In addition, the accuracy-related penalty does not apply if a taxpayer shows there was reasonable cause for an underpayment and the taxpayer acted in good faith.[191]

Penalty for aiding and abetting understatement of tax

A penalty is imposed on a person who: (1) aids or assists in or advises with respect to a tax return or other document; (2) knows (or has reason to believe) that such document will be used in connection with a material tax matter; and (3) knows that this would result in an understatement of tax of another person. In general, the amount of the penalty is $1,000. If the document relates to the tax return of a corporation, the amount of the penalty is $10,000.

Qualified appraisals

Present law requires a taxpayer to obtain a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.[192] Treasury Regulations state that a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under sec-

[190] Sec. 6662(b)(3) and (h).
[191] Sec. 6664(c).
[192] Sec. 170(f)(11).

tion 170; (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[193]

Qualified appraisers

Treasury Regulations define a qualified appraiser as a person who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis, is qualified to make appraisals of the type of property being valued (as determined by the appraiser's background, experience, education and membership, if any, in professional appraisal associations), is independent, and understands that an intentionally false or fraudulent overstatement of the value of the appraised property may subject the appraiser to civil penalties.[194]

Appraiser oversight

The Secretary is authorized to regulate the practice of representatives of persons before the Department of the Treasury ("Department").[195] After notice and hearing, the Secretary is authorized to suspend or disbar from practice before the Department or the Internal Revenue Service ("IRS") a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department or the IRS, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented).

The Secretary also is authorized to bar from appearing before the Department or the IRS, for the purpose of offering opinion evidence on the value of property or other assets, any individual against whom a civil penalty for aiding and abetting the understatement of tax has been assessed. Thus, an appraiser who aids or assists in the preparation or presentation of an appraisal will be subject to disciplinary action if the appraiser knows that the appraisal will be used in connection with the tax laws and will result in an understatement of the tax liability of another person. The Secretary has authority to provide that the appraisals of an appraiser who has been disciplined have no probative effect in any administrative proceeding before the Department or the IRS.

HOUSE BILL

No provision.

SENATE AMENDMENT

Taxpayer penalties

The provision lowers the thresholds for imposing accuracy-related penalties on a taxpayer who claims a deduction for donated

[193] Treas. Reg. sec. 1.170A–13(c)(3).
[194] Treas. Reg. sec. 1.170A–13(c)(5)(i).
[195] 31 U.S.C. sec. 330.

property for which a qualified appraisal is required. Under the provision, a substantial valuation misstatement exists when the claimed value of donated property is 150 percent or more of the amount determined to be the correct value. A gross valuation misstatement occurs when the claimed value of donated property is 200 percent or more the amount determined to be the correct value. Under the provision, the reasonable cause exception to the accuracy-related penalty does not apply in the case of gross valuation misstatements.

Appraiser oversight

Appraiser penalties

The provision establishes a civil penalty on any person who prepares an appraisal that is to be used to support a tax position if such appraisal results in a substantial or gross valuation misstatement. The penalty is equal to the greater of $1,000 or 10 percent of the understatement of tax resulting from a substantial or gross valuation misstatement, up to a maximum of 125 percent of the gross income derived from the appraisal. Under the provision, the penalty does not apply if the appraiser establishes that it was "more likely than not" that the appraisal was correct.

Disciplinary proceeding

The provision eliminates the requirement that the Secretary assess against an appraiser the civil penalty for aiding and abetting the understatement of tax before such appraiser may be subject to disciplinary action. Thus, the Secretary is authorized to discipline appraisers after notice and hearing. Disciplinary action may include, but is not limited to, suspending or barring an appraiser from: preparing or presenting appraisals on the value of property or other assets to the Department or the IRS; appearing before the Department or the IRS for the purpose of offering opinion evidence on the value of property or other assets; and providing that the appraisals of an appraiser who have been disciplined have no probative effect in any administrative proceeding before the Department or the IRS.

Qualified appraisers

The provision defines a qualified appraiser as an individual who (1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements to be determined by the IRS in regulations; (2) regularly performs appraisals for which he or she receives compensation; (3) can demonstrate verifiable education and experience in valuing the type of property for which the appraisal is being performed; (4) has not been prohibited from practicing before the IRS by the Secretary at any time during the three years preceding the conduct of the appraisal; and (5) is not excluded from being a qualified appraiser under applicable Treasury regulations.

Qualified appraisals

The provision defines a qualified appraisal as an appraisal of property prepared by a qualified appraiser (as defined by the provision) in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary.

Effective date

The provision amending the accuracy-related penalty applies to returns filed after the date of enactment. The provision establishing a civil penalty that may be imposed on any person who prepares an appraisal that is to be used to support a tax position if such appraisal results in a substantial or gross valuation misstatement applies to appraisals prepared with respect to returns or submissions filed after the date of enactment. The provisions relating to appraiser oversight apply to appraisals prepared with respect to returns or submissions filed after the date of enactment. With respect to any contribution of a qualified real property interest which is a restriction with respect to the exterior of a building described in section 170(h)(4)(C)(ii) (currently designated section 170(h)(4)(B)(ii), relating to certain property located in a registered historic district and certified as being of historic significance to the district), and any appraisal with respect to such contribution, the provision generally applies to returns filed after December 16, 2004.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

9. Establish additional exemption standards for credit counseling organizations (sec. 221 of the Senate amendment and secs. 501 and 513 of the Code)

PRESENT LAW

Under present law, a credit counseling organization may be exempt as a charitable or educational organization described in section 501(c)(3), or as a social welfare organization described in section 501(c)(4). The IRS has issued two revenue rulings holding that certain credit counseling organizations are exempt as charitable or educational organizations or as social welfare organizations.

In Revenue Ruling 65–299,[196] an organization whose purpose was to assist families and individuals with financial problems, and help reduce the incidence of personal bankruptcy, was determined to be a social welfare organization described in section 501(c)(4). The organization counseled people in financial difficulties, advised applicants on payment of debts, and negotiated with creditors and set up debt repayment plans. The organization did not restrict its services to the poor, made no charge for counseling services, and made a nominal charge for certain services to cover postage and supplies. For financial support, the organization relied on vol-

[196] Rev. Rul. 65–299, 1965–2 C.B. 165.

untary contributions from local businesses, lending agencies, and labor unions.

In Revenue Ruling 69–441,[197] the IRS ruled an organization was a charitable or educational organization exempt under section 501(c)(3) by virtue of aiding low-income people who had financial problems and providing education to the public. The organization in that ruling had two functions: (1) educating the public on personal money management, such as budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications; and (2) providing individual counseling to low-income individuals and families without charge. As part of its counseling activities, the organization established debt management plans for clients who required such services, at no charge to the clients.[198] The organization was supported by contributions primarily from creditors, and its board of directors was comprised of representatives from religious organizations, civic groups, labor unions, business groups, and educational institutions.

In 1976, the IRS denied exempt status to an organization, Consumer Credit Counseling Service of Alabama, whose activities were distinguishable from those in Revenue Ruling 69–441 in that (1) it did not restrict its services to the poor, and (2) it charged a nominal fee for its debt management plans.[199] The organization provided free information to the general public through the use of speakers, films, and publications on the subjects of budgeting, buying practices, and the use of consumer credit. It also provided counseling to debt-distressed individuals, not necessarily poor or low-income, and provided debt management plans at the cost of $10 per month, which was waived in cases of financial hardship. Its debt management activities were a relatively small part of its overall activities. The district court determined the organization qualified as charitable and educational within section 501(c)(3), finding the debt management plans to be an integral part of the agency's counseling function, and that its debt management activities were incidental to its principal functions, as only approximately 12 percent of the counselors' time was applied to such programs and the charge for the service was nominal. The court also considered the facts that the agency was publicly supported, and that it had a board dominated by members of the general public, as factors indicating a charitable operation.[200]

A recent estimate shows the number of credit counseling organizations increased from approximately 200 in 1990 to over 1,000 in 2002.[201] During the period from 1994 to late 2003, 1,215 credit counseling organizations applied to the IRS for tax exempt status

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[197] Rev. Rul. 65–441, 1969–2 C.B. 115.

[198] Debt management plans are debt payment arrangements, including debt consolidation arrangements, entered into by a debtor and one or more of the debtor's creditors, generally structured to reduce the amount of a debtor's regular ongoing payment by modifying the interest rate, minimum payment, maturity or other terms of the debt. Such plans frequently are promoted as a means for a debtor to restructure debt without filing for bankruptcy.

[199] *Consumer Credit Counseling Services of Alabama, Inc.* v. *U.S.*, 44 A.F.T.R. 2d (RIA) 5122 (D.D.C. 1978). The case involved 24 agencies throughout the United States.

[200] See also, *Credit Counseling Centers of Oklahoma, Inc.* v. *U.S.*, 45 A.F.T.R. 2d (RIA) 1401 (D.D.C. 1979) (holding the same on virtually identical facts).

[201] Opening Statement of The Honorable Max Sandlin, Hearing on Non-Profit Credit Counseling Organizations, House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

under section 501(c)(3), including 810 during 2000 to 2003.[202] The IRS has recognized more than 850 credit counseling organizations as tax exempt under section 501c)((3).[203] Few credit counseling organizations have sought section 501(c)(4) status, and the IRS reports it has not seen any significant increase in the number or activity of such organizations operating as social welfare organizations.[204] As of late 2003, there were 872 active tax-exempt credit counseling agencies operating in the United States.[205]

A credit counseling organization described in section 501(c)(3) is exempt from certain Federal and State consumer protection laws that provide exemptions for organizations described therein.[206] Some believe that these exclusions from Federal and State regulation may be a primary motivation for the recent increase in the number of organizations seeking and obtaining exempt status under section 501(c)(3).[207] Such regulatory exemptions generally are not available for social welfare organizations described in section 501(c)(4).

Congress recently conducted hearings investigating the activities of credit counseling organizations under various consumer protection laws,[208] such as the Federal Trade Commission Act.[209] In addition, the IRS has commenced a broad examination and compliance program with respect to the credit counseling industry, pursuant to which the IRS has initiated audits of 50 credit counseling

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[202] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 3 (citing letter dated December 18, 2003, to the Subcommittee from IRS Commissioner Everson).

[203] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[204] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[205] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 3 (citing letter dated December 18, 2003 to the Subcommittee from IRS Commissioner Everson).

[206] E.g., The Credit Repair Organizations Act, 15 U.S.C. section 1679 et seq., effective April 1, 1997 (imposing restrictions on credit repair organizations that are enforced by the Federal Trade Commission, including forbidding the making of untrue or misleading statements and forbidding advance payments; section 501(c)(3) organizations are explicitly exempt from such regulation). Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003) (California's consumer protections laws that impose strict standards on credit service organizations and the credit repair industry do not apply to nonprofit organizations that have received a final determination from the IRS that they are exempt from tax under section 501(c)(3) and are not private foundations).

[207] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[208] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004.

[209] 15 U.S.C. sec. 45(a) (prohibiting unfair and deceptive acts or practices in or affecting commerce; although the Federal Trade Commission generally lacks jurisdiction to enforce consumer protection laws against bona fide nonprofit organizations, it may assert jurisdiction over a nonprofit, including a credit counseling organization, if it demonstrates the organization is organized to carry on business for profit, is a mere instrumentality of a for-profit entity, or operates through a common enterprise with one or more for-profit entities).

organizations, including nine of the 15 largest in terms of gross receipts.[210]

Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, an individual generally may not be a debtor in bankruptcy unless such individual has, within 180 days of filing a petition for bankruptcy, received from an approved nonprofit budget and credit counseling agency an individual or group briefing that outlines the opportunities for available credit counseling and assists the individual in performing a related budget analysis.[211] The clerk of the court must maintain a publicly available list of nonprofit budget and credit counseling agencies approved by the U.S. Trustee (or bankruptcy administrator). In general, the U.S. Trustee (or bankruptcy administrator) shall only approve an agency that demonstrates that it will provide qualified counselors, maintain adequate provision for safekeeping and payment of client funds, provide adequate counseling with respect to client credit problems, and deal responsibly and effectively with other matters relating to the quality, effectiveness, and financial security of the services it provides. The minimum qualifications for approval of such an agency include: (1) in general, having an independent board of directors; (2) charging no more than a reasonable fee, and providing services without regard to ability to pay; (3) adequate provision for safekeeping and payment of client funds; (4) provision of full disclosures to clients; (5) provision of adequate counseling with respect to a client's credit problems; (6) trained counselors who receive no commissions or bonuses based on the outcome of the counseling services; (7) experience and background in providing credit counseling; and (8) adequate financial resources to provide continuing support services for budgeting plans over the life of any repayment plan. An individual debtor must file with the court a certificate from the approved nonprofit budget and credit counseling agency that provided the required services describing the services provided, and a copy of the debt management plan, if any, developed through the agency.[212]

HOUSE BILL

No provision.

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[210] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 31.

[211] This requirement does not apply in certain circumstances, such as: (1) in general, where a debtor resides in a district for which the U.S. Trustee has determined that the approved counseling agencies for such district are not reasonably able to provide adequate services to additional individuals; (2) where exigent circumstances merit a waiver, the individual seeking bankruptcy protection files an appropriate certification with the court, and the certification is acceptable to the court; and (3) in general, where a court determines, after notice and hearing, that the individual is unable to complete the requirement because of incapacity, disability, or active military duty in a military combat zone.

[212] The Act also requires that, prior to discharge of indebtedness under chapter 7 or chapter 13, a debtor complete an approved instructional course concerning personal financial management, which course need not be conducted by a nonprofit agency.

SENATE AMENDMENT

Requirements for exempt status of credit counseling organizations

Under the provision, an organization that provides credit counseling services as a substantial purpose of the organization ("credit counseling organization") is eligible for exemption from Federal income tax only as a charitable or educational organization under section 501(c)(3) or as a social welfare organization under section 501(c)(4), and only if (in addition to present-law requirements) the credit counseling organization is organized and operated in accordance with the following:

1. The organization provides credit counseling services tailored to the specific needs and circumstances of the consumer;

2. The organization makes no loans to debtors and does not negotiate the making of loans on behalf of debtors;

3. The organization generally does not promote, or charge any separate fee for any service for the purpose of improving any consumer's credit record, credit history, or credit rating;

4. The organization does not refuse to provide credit counseling services to a consumer due to inability of the consumer to pay, the ineligibility of the consumer for debt management plan enrollment, or the unwillingness of a consumer to enroll in a debt management plan;

5. The organization establishes and implements a fee policy to require that any fees charged to a consumer for its services are reasonable, and prohibits charging any fee based in whole or in part on a percentage of the consumer's debt, the consumer's payments to be made pursuant to a debt management plan, or on the projected or actual savings to the consumer resulting from enrolling in a debt management plan;

6. The organization at all times has a board of directors or other governing body (a) that is controlled by persons who represent the broad interests of the public, such as public officials acting in their capacities as such, persons having special knowledge or expertise in credit or financial education, and community leaders; (b) not more than 20 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees or the repayment of consumer debt to creditors other than the credit counseling organization or its affiliates) and (c) not more than 49 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees);

7. The organization receives no amount for providing referrals to others for financial services (including debt management services) or credit counseling services to be provided to consumers, and pays no amount to others for obtaining referrals of consumers; and

8. The organization does not own more than 35 percent of the total combined voting power of a corporation (or profits or beneficial interest in the case of a partnership or trust or estate) that is in the business of lending money, repairing credit, or providing

debt management plan services, payment processing, and similar services.

The Secretary may require any credit counseling organization to submit such information as the Secretary requires to verify that such organization meets the requirements of the provision.

Additional requirements for charitable and educational organizations

Under the provision, a credit counseling organization is described in section 501(c)(3) only if, in addition to satisfying the above requirements, the organization is organized and operated such that the organization (1) charges no fees (other than nominal fees) for debt management plan services and waives any fees if the consumer is unable to pay such fees; (2) does not solicit contributions from consumers during the initial counseling process or while the consumer is receiving services from the organization; (3) normally limits debt management plan services (in the aggregate) to 25 percent of the organization's total activities (determined by taking into account time, resources, source of revenues or effort expended by the organization, and any other measures prescribed by the Secretary).[213]

Additional requirements for social welfare organizations

Under the provision, a credit counseling organization is described in section 501(c)(4) only if, in addition to satisfying the above requirements applicable to such organizations, it is organized and operated such that the organization charges no fees (other than nominal fees) for its credit counseling services, and waives any fees if the consumer is unable to pay such fees. In addition, a credit counseling organization shall not be treated as an organization described in section 501(c)(4) unless such organization notifies the Secretary, in such manner as the Secretary may by regulations prescribe, that it is applying for recognition as a credit counseling organization.

Debt management plan services treated as an unrelated trade or business

Under the provision, debt management plan services are treated as an unrelated trade or business for purposes of the tax on income from an unrelated trade or business to the extent such services are not substantially related to the provision of credit counseling services to a consumer or are provided by an organization that is not a credit counseling organization.

Definitions

Credit counseling services

Credit counseling services are (a) the provision of educational information to the general public on budgeting, personal finance, fi-

[213] If, under any such measure, the organization's debt management plan services exceed 25 percent of the organization's total activities, the organization is treated as exceeding the 25-percent limit. For example, an organization that devotes 30 percent of its total staff time to debt management plan services is regarded as exceeding the 25-percent limit, even if the organization devotes less than 15 percent of its total financial resources to debt management plan services.

nancial literacy, saving and spending practices, and the sound use of consumer credit; (b) the assisting of individuals and families with financial problems by providing them with counseling; or (c) any combination of such activities.

Debt management plan services

Debt management plan services are services related to the repayment, consolidation, or restructuring of a consumer's debt, and includes the negotiation with creditors of lower interest rates, the waiver or reduction of fees, and the marketing and processing of debt management plans.

Effective date

In general the provision applies to taxable years beginning after the date of enactment. For a credit counseling organization that is described in section 501(c)(3) or 501(c)(4) on the date of enactment, the provision is effective for taxable years beginning after the date that is one year after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

10. Expand the base of the tax on private foundation net investment income (sec. 222 of the Senate amendment and sec. 4940 of the Code)

PRESENT LAW

In general

Under section 4940(a) of the Code, private foundations that are recognized as exempt from Federal income tax under section 501(a) of the Code are subject to a two-percent excise tax on their net investment income. Private foundations that are not exempt from tax, such as certain charitable trusts,[214] also are subject to an excise tax under section 4940(b) based on net investment income and unrelated business income. The two-percent rate of tax is reduced to one-percent if certain requirements are met in a taxable year.[215] Unlike certain other excise taxes imposed on private foundations, the tax based on investment income does not result from a violation of substantive law by the private foundation; it is solely an excise tax.

The tax on taxable private foundations under section 4940(b) is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation were tax exempt and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code.

[214] See sec. 4947(a)(1).
[215] Sec. 4940(e).

Net investment income

Internal Revenue Code

In general, net investment income is defined as the amount by which the sum of gross investment income and capital gain net income exceeds the deductions relating to the production of gross investment income.[216]

Gross investment income is the gross amount of income from interest, dividends, rents, payments with respect to securities loans, and royalties. Gross investment income does not include any income that is included in computing a foundation's unrelated business taxable income.[217]

Capital gain net income takes into account only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties, and property used for the production of income included in computing the unrelated business income tax (except to the extent the gain or loss is taken into account for purposes of such tax). Losses from sales or other dispositions of property are allowed only to the extent of gains from such sales or other dispositions, and no capital loss carryovers are allowed.[218]

Treasury Regulations and case law

The Treasury regulations elaborate on the Code definition of net investment income. The regulations cite items of investment income listed in the Code, and in addition clarify that net investment income includes interest, dividends, rents, and royalties derived from all sources, including from assets devoted to charitable activities. For example, interest received on a student loan is includible in the gross investment income of a foundation making the loan.[219]

The regulations further provide that gross investment income includes certain items of investment income that are described in the unrelated business income tax regulations.[220] Such additional items include payments with respect to securities loans (an item added to the Code in 1978), annuities, income from notional principal contracts, and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner.[221] These latter three categories of income are not enumerated as net investment income in the Code.

The Treasury regulations also elaborate on the Code definition of capital gain net income. The regulations provide that the only capital gains and losses that are taken into account are (1) gains and losses from the sale or other disposition of property held by a private foundation for investment purposes (other than program related investments), and (2) property used for the production of income included in computing the unrelated business income tax (ex-

[216] Sec. 4940(c)(1). Net investment income also is determined by applying section 103 (generally providing an exclusion for interest on certain State and local bonds) and section 265 (generally disallowing the deduction for interest and certain other expenses with respect to tax-exempt income). Sec. 4940(c)(5).
[217] Sec. 4940(c)(2).
[218] Sec. 4940(c)(4).
[219] Treas. Reg. sec. 53.4940–1(d)(1).
[220] Id.
[221] Treas. Reg. sec. 1.512(b)–1(a)(1).

cept to the extent the gain or loss is taken into account for purposes of such tax).

This definition of capital gain net income builds on the definition provided in the Code by providing an exception for gain and loss from program related investments and by stating, in addition, that "gains and losses from the sale or other disposition of property used for the exempt purposes of the private foundation are excluded."[222] As an example, the regulations provide that gain or loss on the sale of buildings used for the foundation's exempt activities are not taken into account for purposes of the section 4940 tax. If a foundation uses exempt income for exempt purposes and (other than incidentally) for investment purposes, then the portion of the gain or loss received upon sale or other disposition that is allocable to the investment use is taken into account for purposes of the tax.

The regulations further provide that "property shall be treated as held for investment purposes even though such property is disposed of by the foundation immediately upon its receipt, if it is property of a type which generally produces interest, dividends, rents, royalties, or capital gains through appreciation (for example, rental real estate, stock, bonds, mineral interest, mortgages, and securities)."[223]

This regulation has been challenged in the courts. The regulation says that property is treated as held for investment purposes if it is of a type that "generally produces" certain types of income. By contrast, the Code provides that the property be "used" to produce such income. In *Zemurray Foundation* v. *United States,* 687 F.2d 97 (5th Cir. 1982), the taxpayer foundation challenged the Treasury's attempt to tax under section 4940 capital gain on the sale of timber property. The taxpayer asserted that the property was not actually used to produce investment income, and that the Treasury Regulation was invalid because the regulation would subject to tax property that is of a type that could generally be used to produce investment income. On this issue, the court upheld the Treasury regulation, reasoning that the regulation's use of the phrase "generally used," though permitting taxation "so long as the property sold is usable to produce the applicable types of income, regardless of whether the property is actually used to produce income or not" was not unreasonable or plainly inconsistent with the statute.[224] However, on remand to the district court, the district court concluded that the timber property at issue, though a type of property generally used to produce investment income, was not susceptible for such use.[225] Thus, the district court concluded that the Treasury could not tax the gain under this portion of the regulation.

The question then turned to the taxpayer's second challenge to the regulation. At issue was the meaning of the regulatory phrase "capital gains through appreciation." The regulation provides that if property is of a type that generally produces capital gains through appreciation, then the gain is subject to tax. The Treasury argued that the timber property at issue, although held by the

[222] Treas. Reg. sec. 53.4940–1(f)(1).
[223] Id.
[224] *Zemurray Foundation* v. *United States,* 687 F.2d 97, 100 (5th Cir. 1982).
[225] *Zemurray Foundation* v. *United States,* 53 A.F.T.R. 2d (RIA) 842 (E. D. La. 1983).

court not to be property (in this case) susceptible for use to produce interest, dividends, rents, or royalties, still was held by the taxpayer to produce capital gain through appreciation and therefore the gain should be subject to tax under the regulation.

On this issue, the court held for the taxpayer, reasoning that the language of the Code clearly is limited to certain gains and losses, e.g., the court cited the Code language providing that "there shall be taken into account only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties. . . ."[226] The court noted that "capital gains through appreciation" is not enumerated in the statute. The court used as an example a jade figurine held by a foundation. Jade figurines do not generally produce interest, dividends, rents, or royalties, but gain on the sale of such a figurine would be taxable under the "capital gains through appreciation" standard, yet such standard does not appear in the statute. After Zemurray, the Treasury generally conceded this issue.[227]

With respect to capital losses, the Code provides that carryovers are not permitted, whereas the regulations state that neither carryovers nor carrybacks are permitted.[228]

Application of Zemurray to the Code and the regulations

Applying the Zemurray case to the Code and regulations results in a general principle for purposes of present law: private foundations are subject to tax under section 4940 only on the items of income and only on gains and losses specifically enumerated therein. Under this principle, private foundations generally are not subject to the section 4940 tax on other substantially similar types of income from ordinary and routine investments, notwithstanding Treasury regulations to the contrary. In addition, the regulations provide that gain or loss from the sale or other disposition of assets used for exempt purposes, with specific reference to program-related investments, is excluded. The Code provides for no such blanket exclusion; thus, under the language of the Code and the reasoning of Zemurray, if a foundation provided office space at below market rent to a charitable organization for use in the organization's exempt purposes, gain on the sale of the building by the foundation should be subject to the section 4940 tax despite the Treasury regulations.[229]

In addition, under the logic of Zemurray, capital loss carrybacks arguably are permitted, notwithstanding Treasury regulations to the contrary, because the Code mentions only a bar on use of carryovers and says nothing about carrybacks.

HOUSE BILL

No provision.

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[226] *Zemurray Foundation* v. *United States,* 755 F.2d 404 (5th Cir. 1985), 413 (citing Code sec. 4940(c)(4)(A).

[227] G.C.M. 39538 (July 23, 1986).

[228] Treas. Reg. sec. 53.4940–1(f)(3).

[229] See also the example in Treas. Reg. sec. 53.4940–1(f)(1).

SENATE AMENDMENT

The provision amends the definition of gross investment income (including for purposes of capital gain net income) to include items of income that are similar to the items presently enumerated in the Code. Such similar items include income from notional principal contracts, annuities, and other substantially similar income from ordinary and routine investments, and, with respect to capital gain net income, capital gains from appreciation, including capital gains and losses from the sale or other disposition of assets used to further an exempt purpose.

The provision provides that there are no carrybacks of losses from sales or other dispositions of property.

Effective date.—The provision is effective for taxable years beginning after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

11. Definition of convention or association of churches (sec. 223 of the Senate amendment and sec. 7701 of the Code)

PRESENT LAW

Under present law, an organization that qualifies as a "convention or association of churches" (within the meaning of sec. 170(b)(1)(A)(i)) is not required to file an annual return,[230] is subject to the church tax inquiry and church tax examination provisions applicable to organizations claiming to be a church,[231] and is subject to certain other provisions generally applicable to churches.[232] The Internal Revenue Code does not define the term "convention or association of churches."

HOUSE BILL

No provision.

SENATE AMENDMENT

The provision provides that an organization that otherwise is a convention or association of churches does not fail to so qualify merely because the membership of the organization includes individuals as well as churches, or because individuals have voting rights in the organization.

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[230] Sec. 6033(a)(2)(A)(i).

[231] Sec. 7611(h)(1)(B).

[232] See, e.g., Sec. 402(g)(8)(B) (limitation on elective deferrals); sec. 403(b)(9)(B) (definition of retirement income account); sec. 410(d) (election to have participation, vesting, funding, and certain other provisions apply to church plans); sec. 414(e) (definition of church plan); sec. 415(c)(7) (certain contributions by church plans); sec. 501(h)(5) (disqualification of certain organizations from making the sec. 501(h) election regarding lobbying expenditure limits); sec. 501(m)(3) (definition of commercial-type insurance); sec. 508(c)(1)(A) (exception from requirement to file application seeking recognition of exempt status); sec. 512(b)(12) (allowance of up to $1,000 deduction for purposes of determining unrelated business taxable income); sec. 514(b)(3)(E) (definition of debt-financed property); sec. 3121(w)(3)(A) (election regarding exemption from social security taxes); sec. 3309(b)(1) (application of federal unemployment tax provisions to services performed in the employ of certain organizations); sec. 6043(b)(1) (requirement to file a return upon liquidation or dissolution of the organization); and sec. 7702(j)(3)(A) (treatment of certain death benefit plans as life insurance).

Effective date.—The provision is effective on the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

12. Notification requirement for exempt entities not currently required to file an annual information return (sec. 224 of the Senate amendment and secs. 6033, 6104, 6652, and 7428 of the Code)

PRESENT LAW

Under present law, the requirement that an exempt organization file an annual information return does not apply to several categories of exempt organizations. Organizations excepted from the filing requirement include organizations (other than private foundations), the gross receipts of which in each taxable year normally are not more than $25,000.[233] Also exempt from the requirement are churches, their integrated auxiliaries, and conventions or associations of churches; the exclusively religious activities of any religious order; section 501(c)(1) instrumentalities of the United States; section 501(c)(21) trusts; an interchurch organization of local units of a church; certain mission societies; certain church-affiliated elementary and high schools; certain state institutions whose income is excluded from gross income under section 115; certain governmental units and affiliates of governmental units; and other organizations that the IRS has relieved from the filing requirement pursuant to its statutory discretionary authority.

HOUSE BILL

No provision.

SENATE AMENDMENT

The provision provides that organizations that are excused from filing an information return by reason of normally having gross receipts below a certain specified amount (generally, under $25,000) shall furnish to the Secretary annually the legal name of the organization, any name under which the organization operates or does business, the organization's mailing address and Internet web site address (if any), the organization's taxpayer identification number, the name and address of a principal officer, and evidence of the organization's continuing basis for its exemption from the generally applicable information return filing requirements. Upon such organization's termination of existence, the organization is required to furnish notice of such termination.

The provision provides that if an organization fails to provide the required notice for three consecutive years, the organization's

[233] Sec. 6033(a)(2); Treas. Reg. sec. 1.6033–2(a)(2)(i); Treas. Reg. sec. 1.6033–2(g)(1). Sec. 6033(a)(2)(A)(ii) provides a $5,000 annual gross receipts exception from the annual reporting requirements for certain exempt organizations. In Announcement 82–88, 1982–25 I.R.B. 23, the IRS exercised its discretionary authority under section 6033 to increase the gross receipts exception to $25,000, and enlarge the category of exempt organizations that are not required to file Form 990.

tax-exempt status is revoked. In addition, if an organization that is required to file an annual information return under section 6033(a) (Form 990) fails to file such an information return for three consecutive years, the organization's tax-exempt status is revoked. If an organization fails to meet its filing obligation to the IRS for three consecutive years in cases where the organization is subject to the information return filing requirement in one or more years during a three-year period and also is subject to the notice requirement for one or more years during the same three-year period, the organization's tax-exempt status is revoked.

A revocation under the provision is effective from the date that the Secretary determines was the last day the organization could have timely filed the third required information return or notice. To again be recognized as tax-exempt, the organization must apply to the Secretary for recognition of tax-exemption, irrespective of whether the organization was required to make an application for recognition of tax-exemption in order to gain tax-exemption originally.

If upon application for tax-exempt status after a revocation under the provision, the organization shows to the satisfaction of the Secretary reasonable cause for failing to file the required annual notices or returns, the organization's tax-exempt status may, in the discretion of the Secretary, be reinstated retroactive to the date of revocation. An organization may not challenge under the Code's declaratory judgment procedures (section 7428) a revocation of tax-exemption made pursuant to the provision.

There is no monetary penalty for failure to file the notice. The provision does not require that the notices be made available to the public under the public disclosure and inspection rules generally applicable to exempt organizations. The provision does not affect an organization's obligation under present law to file required information returns or existing penalties for failure to file such returns.

The Secretary is required to notify in a timely manner every organization that is subject to the notice filing requirement of the new filing obligation. Notification by the Secretary shall be by mail, in the case of any organization the identity and address of which is included in the list of exempt organizations maintained by the Secretary, and by Internet or other means of outreach, in the case of any other organization. In addition, the Secretary is required to publicize in a timely manner in appropriate forms and instructions and other means of outreach the new penalty imposed for consecutive failures to file the information return.

The Secretary is authorized to publish a list of organizations whose exempt status is revoked under the provision.

Effective date.—The provision is effective for notices and returns with respect to annual periods beginning after 2005.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

13. Disclosure to state officials of proposed actions related to section 501(c) organizations (sec. 225 of the Senate amendment and secs. 6103, 6104, 7213, 7213A, and 7431 of the Code)

PRESENT LAW

In the case of organizations that are described in section 501(c)(3) and exempt from tax under section 501(a) or that have applied for exemption as an organization so described, present law (sec. 6104(c)) requires the Secretary to notify the appropriate State officer of (1) a refusal to recognize such organization as an organization described in section 501(c)(3), (2) a revocation of a section 501(c)(3) organization's tax-exempt status, and (3) the mailing of a notice of deficiency for any tax imposed under section 507, chapter 41, or chapter 42.[234] In addition, at the request of such appropriate State officer, the Secretary is required to make available for inspection and copying, such returns, filed statements, records, reports, and other information relating to the above-described disclosures, as are relevant to any State law determination. An appropriate State officer is the State attorney general, State tax officer, or any State official charged with overseeing organizations of the type described in section 501(c)(3).

In general, returns and return information (as such terms are defined in section 6103(b)) are confidential and may not be disclosed or inspected unless expressly provided by law.[235] Present law requires the Secretary to keep records of disclosures and requests for inspection[236] and requires that persons authorized to receive returns and return information maintain various safeguards to protect such information against unauthorized disclosure.[237] Willful unauthorized disclosure or inspection of returns or return information is subject to a fine and/or imprisonment.[238] The knowing or negligent unauthorized inspection or disclosure of returns or return information gives the taxpayer a right to bring a civil suit.[239] Such present-law protections against unauthorized disclosure or inspection of returns and return information do not apply to the disclosures or inspections, described above, that are authorized by section 6104(c).

HOUSE BILL

No provision.

SENATE AMENDMENT

The provision provides that upon written request by an appropriate State officer, the Secretary may disclose: (1) a notice of proposed refusal to recognize an organization as a section 501(c)(3) or-

[234] The applicable taxes include the termination tax on private foundations; taxes on public charities for certain excess lobbying expenses; taxes on a private foundation's net investment income, self-dealing activities, undistributed income, excess business holdings, investments that jeopardize charitable purposes, and taxable expenditures (some of these taxes also apply to certain non-exempt trusts); taxes on the political expenditures and excess benefit transactions of section 501(c)(3) organizations; and certain taxes on black lung benefit trusts and foreign organizations.

[235] Sec. 6103(a).

[236] Sec. 6103(p)(3).

[237] Sec. 6103(p)(4).

[238] Secs. 7213 and 7213A.

[239] Sec. 7431.

ganization; (2) a notice of proposed revocation of tax-exemption of a section 501(c)(3) organization; (3) the issuance of a proposed deficiency of tax imposed under section 507, chapter 41, or chapter 42; (4) the names, addresses, and taxpayer identification numbers of organizations that have applied for recognition as section 501(c)(3) organizations; and (5) returns and return information of organizations with respect to which information has been disclosed under (1) through (4) above.[240] Disclosure or inspection is permitted for the purpose of, and only to the extent necessary in, the administration of State laws regulating section 501(c)(3) organizations, such as laws regulating tax-exempt status, charitable trusts, charitable solicitation, and fraud. Such disclosure or inspection may be made only to or by an appropriate State officer or to an officer or employee of the State who is designated by the appropriate State officer, and may not be made by or to a contractor or agent. The Secretary also is permitted to disclose or open to inspection the returns and return information of an organization that is recognized as tax-exempt under section 501(c)(3), or that has applied for such recognition, to an appropriate State officer if the Secretary determines that disclosure or inspection may facilitate the resolution of Federal or State issues relating to the tax-exempt status of the organization. For this purpose, appropriate State officer means the State attorney general, the State tax official, or any other State official charged with overseeing organizations of the type described in section 501(c)(3).

In addition, the provision provides that upon the written request by an appropriate State officer, the Secretary may make available for inspection or disclosure returns and return information of an organization described in section 501(c)(2) (certain title holding companies), 501(c)(4) (certain social welfare organizations), 501(c)(6) (certain business leagues and similar organizations), 501(c)(7) (certain recreational clubs), 501(c)(8) (certain fraternal organizations), 501(c)(10) (certain domestic fraternal organizations operating under the lodge system), and 501(c)(13) (certain cemetery companies). Such returns and return information are available for inspection or disclosure only for the purpose of, and to the extent necessary in, the administration of State laws regulating the solicitation or administration of the charitable funds or charitable assets of such organizations. Such disclosure or inspection may be made only to or by an appropriate State officer or to an officer or employee of the State who is designated by the appropriate State officer, and may not be made by or to a contractor or agent. For this purpose, appropriate State officer means the State attorney general, the State tax officer, and the head of an agency designated by the State attorney general as having primary responsibility for overseeing the solicitation of funds for charitable purposes of such organizations.

In addition, the provision provides that any returns and return information disclosed under section 6104(c) may be disclosed in civil administrative and civil judicial proceedings pertaining to the enforcement of State laws regulating the applicable tax-exempt or-

[240] Such returns and return information also may be open to inspection by an appropriate State officer.

ganization in a manner prescribed by the Secretary. Returns and return information are not to be disclosed under section 6104(c), or in such an administrative or judicial proceeding, to the extent that the Secretary determines that such disclosure would seriously impair Federal tax administration. The provision makes disclosures of returns and return information under section 6104(c) subject to the disclosure, recordkeeping, and safeguard provisions of section 6103, including the requirements that the Secretary maintain a permanent system of records of requests for disclosure (sec. 6103(p)(3)), and that the appropriate State officer maintain various safeguards that protect against unauthorized disclosure (sec. 6103(p)(4)). The provision provides that the willful unauthorized disclosure of returns or return information described in section 6104(c) is a felony subject to a fine of up to $5,000 and/or imprisonment of up to five years (sec. 7213(a)(2)), the willful unauthorized inspection of returns or return information described in section 6104(c) is subject to a fine of up to $1,000 and/or imprisonment of up to one year (sec. 7213A), and provides the taxpayer the right to bring a civil action for damages in the case of knowing or negligent unauthorized disclosure or inspection of such information (sec. 7431(a)(2)).

Effective date.—The provision is effective on the date of enactment but does not apply to requests made before such date.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

14. Improve accountability of donor advised funds (secs. 231 through 234 of the Senate amendment and secs. 170 and 4958 and new secs. 4967, 4968, and 4969 of the Code)

PRESENT LAW

Requirements for section 501(c)(3) tax-exempt status

Charitable organizations, i.e., organizations described in section 501(c)(3), generally are exempt from Federal income tax and are eligible to receive tax deductible contributions. A charitable organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.[241] In order to qualify as operating primarily for a purpose described in section 501(c)(3), an organization must satisfy the following operational requirements: (1) the net earnings of the organization may not inure to the benefit of any person in a position to influence the activities of the organization; (2) the organization must operate to provide a public benefit, not a private benefit;[242] (3) the organization may not be operated primarily to conduct an unrelated trade or business;[243] (4) the organization may not engage in substantial

[241] Treas. Reg. sec. 1.501(c)(3)–1(c)(1). The Code specifies such purposes as religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. In general, an organization is organized and operated for charitable purposes if it provides relief for the poor and distressed or the underprivileged. Treas. Reg. sec. 1.501(c)(3)–1(d)(2).

[242] Treas. Reg. sec. 1.501(c)(3)–1(d)(1)(ii).

[243] Treas. Reg. sec. 1.501(c)(3)–1(e)(1). Conducting a certain level of unrelated trade or business activity will not jeopardize tax-exempt status.

legislative lobbying; and (5) the organization may not participate or intervene in any political campaign.

Classification of section 501(c)(3) organizations

Section 501(c)(3) organizations are classified either as "public charities" or "private foundations."[244] Private foundations generally are defined under section 509(a) as all organizations described in section 501(c)(3) other than an organization granted public charity status by reason of: (1) being a specified type of organization (i.e., churches, educational institutions, hospitals and certain other medical organizations, certain organizations providing assistance to colleges and universities, or a governmental unit); (2) receiving a substantial part of its support from governmental units or direct or indirect contributions from the general public; or (3) providing support to another section 501(c)(3) entity that is not a private foundation. In contrast to public charities, private foundations generally are funded from a limited number of sources (e.g., an individual, family, or corporation). Donors to private foundations and persons related to such donors together often control the operations of private foundations.

Because private foundations receive support from, and typically are controlled by, a small number of supporters, private foundations are subject to a number of anti-abuse rules and excise taxes not applicable to public charities.[245] For example, the Code imposes excise taxes on acts of "self-dealing" between disqualified persons (generally, an enumerated class of foundation insiders[246]) and a private foundation. Acts of self-dealing include, for example, sales or exchanges, or leasing, of property; lending of money; or the furnishing of goods, services, or facilities between a disqualified person and a private foundation.[247] In addition, private non-operating foundations are required to pay out a minimum amount each year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization's exempt purposes, including reasonable and necessary administrative expenses.[248] Certain expenditures of private foundations are also subject to tax.[249] In general, taxable expenditures are expenditures: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility[250] with respect to

[244] Sec. 509(a). Private foundations are either private operating foundations or private non-operating foundations. In general, private operating foundations operate their own charitable programs in contrast to private non-operating foundations, which generally are grant-making organizations. Most private foundations are non-operating foundations.

[245] Secs. 4940–4945.

[246] See sec. 4946(a).

[247] Sec. 4941.

[248] Sec. 4942(g)(1)(A). A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's exempt purposes and certain amounts set-aside for exempt purposes. Sec. 4942(g)(1)(B) and 4942(g)(2).

[249] Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[250] In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose

Continued

the grant; or (5) for any non-charitable purpose. Additional excise taxes may also apply in the event a private foundation holds certain business interests ("excess business holdings")[251] or makes an investment that jeopardizes the foundation's exempt purposes.[252]

Supporting organizations

The Code provides that certain "supporting organizations" (in general, organizations that provide support to another section 501(c)(3) organization that is not a private foundation) are classified as public charities rather than private foundations.[253] To qualify as a supporting organization, an organization must meet all three of the following tests: (1) it must be organized and at all times operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more "publicly supported organizations"[254] (the "organizational and operational tests");[255] (2) it must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations (the "relationship test");[256] and (3) it must not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations (the "lack of outside control test").[257]

To satisfy the relationship test, a supporting organization must hold one of three statutorily described close relationships with the supported organization. The organization must be: (1) operated, supervised, or controlled by a publicly supported organization (commonly referred to as "Type I" supporting organizations); (2) supervised or controlled in connection with a publicly supported organization ("Type II" supporting organizations); or (3) operated in connection with a publicly supported organization ("Type III" supporting organizations).[258]

Type I supporting organizations

In the case of supporting organizations that are operated, supervised, or controlled by one or more publicly supported organizations (Type I supporting organizations), one or more supported organizations must exercise a substantial degree of direction over the policies, programs, and activities of the supporting organization.[259] The relationship between the Type I supporting organization and the supported organization generally is comparable to that of a parent and subsidiary. The requisite relationship may be established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their

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for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

[251] Sec. 4943.

[252] Sec. 4944.

[253] Sec. 509(a)(3).

[254] In general, supported organizations of a supporting organization must be publicly supported charities described in sections 509(a)(1) or (a)(2).

[255] Sec. 509(a)(3)(A).

[256] Sec. 509(a)(3)(B).

[257] Sec. 509(a)(3)(C).

[258] Treas. Reg. sec. 1.509(a)–4(f)(2).

[259] Treas. Reg. sec. 1.509(a)–4(g)(1)(i).

official capacity, or the membership of one or more publicly supported organizations.[260]

Type II supporting organizations

Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations. Rather than the parent-subsidiary relationship characteristic of Type I organizations, the relationship between a Type II organization and its supported organizations is more analogous to a brother-sister relationship. In order to satisfy the Type II relationship requirement, generally there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations.[261] An organization generally is not considered to be "supervised or controlled in connection with" a publicly supported organization merely because the supporting organization makes payments to the publicly supported organization, even if the obligation to make payments is enforceable under state law.[262]

Type III supporting organizations

Type III supporting organizations are "operated in connection with" one or more publicly supported organizations. To satisfy the "operated in connection with" relationship, Treasury regulations require that the supporting organization be responsive to, and significantly involved in the operations of, the publicly supported organization. This relationship is deemed to exist where the supporting organization meets both a "responsiveness test" and an "integral part test."[263] In general, the responsiveness test requires that the Type III supporting organization be responsive to the needs or demands of the publicly supported organizations. In general, the integral part test requires that the Type III supporting organization maintain significant involvement in the operations of one or more publicly supported organizations, and that such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides.

Charitable contributions

Contributions to organizations described in section 501(c)(3) are deductible, subject to certain limitations, as an itemized deduction from Federal income taxes.[264] Such contributions also generally are deductible for estate and gift tax purposes.[265] However, if the taxpayer retains control over the assets transferred to charity, the transfer may not qualify as a completed gift for purposes of claiming an income, estate, or gift tax deduction.

Public charities enjoy certain advantages over private foundations regarding the deductibility of contributions. For example, contributions of appreciated capital gain property to a private foundation generally are deductible only to the extent of the donor's cost

[260] Id.
[261] Treas. Reg. sec. 1.509(a)–4(h)(1).
[262] Treas. Reg. sec. 1.509(a)–4(h)(2).
[263] Treas. Reg. sec. 1.509(a)–4(i)(1).
[264] Sec. 170.
[265] Secs. 2055 and 2522.

basis.[266] In contrast, contributions to public charities generally are deductible in an amount equal to the property's fair market value, except for gifts of inventory and other ordinary income property, short-term capital gain property, and tangible personal property the use of which is unrelated to the donee organization's exempt purpose. In addition, under present law, a taxpayer's deductible contributions generally are limited to specified percentages of the taxpayer's contribution base, which generally is the taxpayer's adjusted gross income for a taxable year. The applicable percentage limitations vary depending upon the type of property contributed and the classification of the donee organization. In general, contributions to non-operating private foundations are limited to a smaller percentage of the donor's contribution base (up to 30 percent) than contributions to public charities (up to 50 percent).[267]

In general, taxpayers who make contributions and claim a charitable deduction must satisfy recordkeeping and substantiation requirements.[268] The requirements vary depending on the type and value of property contributed. A deduction generally may be denied if the donor fails to satisfy applicable recordkeeping or substantiation requirements.

Intermediate sanctions (excess benefit transaction tax)

The Code imposes excise taxes on excess benefit transactions between disqualified persons and public charities.[269] An excess benefit transaction generally is a transaction in which an economic benefit is provided by a public charity directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

For purposes of the excess benefit transaction rules, a disqualified person is any person in a position to exercise substantial influence over the affairs of the public charity at any time in the five-year period ending on the date of the transaction at issue.[270] Persons holding certain powers, responsibilities, or interests (e.g., officers, directors, or trustees) are considered to be in a position to exercise substantial influence over the affairs of the public charity.

An excess benefit transaction tax is imposed on the disqualified person and, in certain cases, on the organization managers, but is not imposed on the public charity. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected within a specified period. A tax of 10 percent of the excess benefit (not to exceed $10,000 with respect to any excess benefit transaction) is imposed on an organization manager

[266] A special rule in section 170(e)(5) provides that taxpayers are allowed a deduction equal to the fair market value of certain contributions of appreciated, publicly traded stock contributed to a private foundation.

[267] Sec. 170(b).

[268] Sec. 170(f)(8).

[269] Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status. The tax also applies to transactions between disqualified persons and social welfare organizations (as described in section 501(c)(4)).

[270] Sec. 4958(f)(1). A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons.

that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.

Community foundations

Community foundations generally are broadly supported section 501(c)(3) public charities that make grants to other charitable organizations located within a community foundation's particular geographic area. Donors sometimes make contributions to a community foundation through transfers to a separate trust or fund, the assets of which are held and managed by a bank or investment company.

Certain community foundations are subject to special rules that permit them to treat the separate funds or trusts maintained by the community foundation as a single entity for tax purposes. This "single entity" status allows the community foundation to be classified as a public charity. One of the requirements that community foundations must meet is that funds maintained by the community foundation may not be subject by the donor to any material restrictions or conditions. The prohibition against material restrictions or conditions is designed to prevent a donor from encumbering a fund in a manner that prevents the community foundation from freely distributing the assets and income from it in furtherance of the community foundation's charitable purposes. Under Treasury regulations, whether a particular restriction or condition placed by the donor on the transfer of assets is material must be determined from all of the facts and circumstances of the transfer. The regulations set out some of the more significant facts and circumstances to be considered in making a determination, including: (1) whether the transferee public charity is the fee owner of the assets received; (2) whether the assets are held and administered by the public charity in a manner consistent with its own exempt purposes; (3) whether the governing body of the public charity has the ultimate authority and control over the assets and the income derived from them; and (4) whether the governing body of the public charity is independent from the donor. The regulations provide several non-adverse factors for determining whether a particular restriction or condition placed by the donor on the transfer of assets is material. In addition, the regulations list numerous factors and subfactors that indicate that the community foundation is prevented from freely and effectively employing the donated assets and the income thereon.

Donor advised funds

Some charitable organizations (including community foundations) establish accounts to which donors may contribute and thereafter provide nonbinding advice or recommendations with regard to distributions from the fund or the investment of assets in the fund. Such accounts are commonly referred to as "donor advised funds." Donors who make contributions to charities for maintenance in a donor advised fund generally claim a charitable contribution deduction at the time of the contribution. Although sponsoring charities frequently permit donors (or other persons appointed by donors) to provide nonbinding recommendations concerning the distribution or

investment of assets in a donor advised fund, sponsoring charities generally must have legal ownership and control of such assets following the contribution. If the sponsoring charity does not have such control (or permits a donor to exercise control over amounts contributed), the donor's contributions may not qualify for a charitable deduction, and, in the case of a community foundation, the contribution may be treated as being subject to a material restriction or condition by the donor.

In recent years, a number of financial institutions have formed charitable corporations for the principal purpose of offering donor advised funds, sometimes referred to as "commercial" donor advised funds. In addition, some established charities have begun operating donor advised funds in addition to their primary activities. The IRS has recognized several organizations that sponsor donor advised funds, including "commercial" donor advised funds, as section 501(c)(3) public charities. The term "donor advised fund" is not defined in statute or regulations.

Under the Katrina Emergency Tax Relief Act of 2005, certain of the above-described percent limitations on contributions to public charities are temporarily suspended for purposes of certain "qualified contributions" to public charities. Under the Act, qualified contributions do not include a contribution if the contribution is for establishment of a new, or maintenance in an existing, segregated fund or account with respect to which the donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to distributions or investments by reason of the donor's status as a donor.

HOUSE BILL

No provision.

SENATE AMENDMENT

Definitions

Donor advised fund

The provision defines a "donor advised fund" as a fund or account that is: (1) separately identified by reference to contributions of a donor or donors[271] (2) owned and controlled by a sponsoring organization and (3) with respect to which a donor (or any person appointed or designated by such donor (a "donor advisor")) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the separately identified fund or account by reason of the donor's status as a donor.

Notwithstanding the foregoing, the term "donor advised fund" does not include a fund or account from which are made grants to individuals for travel, study, or other similar purposes by such individual, provided that (1) a donor's or donor advisor's advisory privileges are performed exclusively by such donor or donor advisor in such person's capacity as a member of a committee appointed by

[271] The requirement that a donor advised fund be separately identified by reference to contributions of a donor or donors is intended to exclude from the definition of "donor advised fund" certain types of funds or accounts maintained by community foundations and other charities, such as field-of-interest funds and scholarship funds, provided such funds or accounts are not separately identified by reference to contributions of a donor or donors.

the sponsoring organization, (2) no combination of a donor and persons related to or appointed by such donor, control, directly or indirectly, such committee, and (3) all grants from such fund or account satisfy requirements similar to those described in section 4945(g) (concerning grants to individuals by private foundations). In addition, the Secretary may exempt a fund or account from treatment as a donor advised fund if such fund or account (1) is advised by a committee not directly or indirectly controlled by a donor, donor advisor, or persons related to a donor or donor advisor or (2) will benefit a single identified organization or governmental entity or a single identified charitable purpose.

Sponsoring organization

The provision defines a "sponsoring organization" as an organization that: (1) is described in section 170(c)[272] (other than a governmental entity described in section 170(c)(1), and without regard to any requirement that the organization be organized in the United States[273]); and (2) maintains one or more donor advised funds.

Investment advisor

Under the provision, the term "investment advisor" means, with respect to any sponsoring organization, any person (other than an employee of the sponsoring organization) compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds owned by the sponsoring organization.

Deductibility of contributions to a sponsoring organization for maintenance in a donor advised fund

Contributions to certain sponsoring organizations for maintenance in a donor advised fund not eligible for a charitable deduction

Under the provision, contributions to a sponsoring organization for maintenance in a donor advised fund are not eligible for a charitable deduction for income tax purposes if the sponsoring organization is a veterans' organization described in section 170(c)(3), a fraternal society described in section 170(c)(4), or a cemetery company described in section 170(c)(5); for gift tax purposes if the sponsoring organization is a fraternal society described in section 2522(a)(3) or a veterans' organization described in section 2522(a)(4); or for estate tax purposes if the sponsoring organization is a fraternal society described in section 2055(a)(3) or a veterans' organization described in section 2055(a)(4). In addition, contributions to a sponsoring organization for maintenance in a donor advised fund are not eligible for a charitable deduction if the sponsoring organization is a Type III supporting organization; a deduction is allowed for such a contribution to a Type I or Type II supporting organization to the extent not prohibited by regulations. Regulations generally shall prohibit such a deduction where the donor of the con-

[272] Section 170(c) describes organizations to which charitable contributions that are deductible for income tax purposes can be made.
[273] See sec. 170(c)(2)(A).

tribution directly or indirectly controls a supported organization of the Type I or Type II supporting organization.

Additional substantiation requirements

In addition to satisfying present-law substantiation requirements under section 170(f), a donor must obtain, with respect to each charitable contribution to a sponsoring organization to be maintained in a donor advised fund, a contemporaneous written acknowledgment from the sponsoring organization providing that the sponsoring organization has exclusive legal control over the assets contributed.

Minimum distributions

Aggregate distribution requirement

Under the provision, a sponsoring organization is required, for each taxable year of the organization, to make qualifying distributions, from the assets of donor advised funds maintained by the organization, equivalent to the applicable percentage of the aggregate asset value of donor advised funds maintained by the sponsoring organization as determined on the last day of the immediately preceding taxable year. Such qualifying distributions generally must be made by the first day of the second taxable year following the taxable year. The provision excludes from the computation of the required distributable amount for a taxable year the assets of donor advised funds that have been in existence for less than one full year as of the end of the immediately preceding taxable year.[274] The aggregate payout rule does not apply in the case of a donor advised fund maintained by a private foundation that is subject to the requirements of section 4942. The applicable percentage is three percent for the first taxable year beginning after the date of enactment, four percent for the second such taxable year, and five percent for any such taxable year thereafter.

Generally applicable account-level activity requirement

Under the provision, a sponsoring organization must distribute from each of its donor advised funds at least a certain amount in qualifying distributions during any applicable three-year period by the 181st day of the first taxable year following such period. The required distributable amount is the greater of (1) $250 or (2) two and one-half percent of the sponsoring organization's average required minimum initial contribution amount for such period[275] (or average required minimum balance, if greater) for the type of donor[276] at issue. An applicable three-year period must correspond

[274] Assume, for example, that a sponsoring organization initially maintained 10 donor advised funds, each established in Year 1. In Year 3, a new donor advised fund is established. For purposes of determining the sponsoring organization's aggregate payout requirement for Year 4, the donor advised fund established in Year 3 is excluded, because it was in existence for less than a year as of the end of Year 3. For these purposes, a donor advised fund is considered created when the account is first established (rather than, for example, when a donor achieves the minimum account balance required under the sponsoring organization's rules to begin grantmaking).

[275] For purposes of the provision, the required minimum initial contribution amount is the minimum contribution amount required by the sponsoring organization in order to open a donor advised fund.

[276] Under some circumstances, for example, a sponsoring organization may establish higher minimum initial contribution amounts for corporate donors than for individual donors.

with three consecutive taxable years of the sponsoring organization. The first applicable three-year period for a donor advised fund begins only after the fund has been in existence for one full year.[277]

Account-level distribution requirement for accounts that hold illiquid assets

If, as of the end of any taxable year of the sponsoring organization, a donor advised fund holds assets other than cash and marketable securities (i.e., "illiquid assets") that equal more than 10 percent of the total value of assets in the fund (determined using the valuation procedures described below), the donor advised fund is considered to be an "illiquid asset donor advised fund" for the subsequent taxable year of the sponsoring organization. A sponsoring organization must distribute from each illiquid asset donor advised fund as qualifying distributions by the 181st day of the second taxable year following such subsequent taxable year an amount equal to the applicable percentage of the value of the assets in the donor advised fund as of the end of such year (the "illiquid asset payout requirement"). The applicable percentage is three percent for the first taxable year beginning after the date of enactment, four percent for the second such taxable year, and five percent for any such taxable year thereafter.

If, as of the end of a taxable year of the sponsoring organization, an illiquid asset in a donor advised fund has not been held for a period of 12 months, such asset is not considered an illiquid asset for such year. However, if an illiquid asset has been exchanged for another illiquid asset, then the holding period for any such other illiquid asset includes the period during which the illiquid asset that was exchanged was held. The Secretary is authorized to promulgate anti-abuse rules to prevent the circumvention of the provision through transactions designed to avoid application of illiquid asset payout requirement, such as through exchanges of illiquid assets for other assets.

Qualifying distributions

For purposes of all of the distribution requirements described in the provision, qualifying distributions are amounts paid to organizations described in section 170(b)(1)(A) (other than Type III supporting organizations or a sponsoring organization if the amount is for maintenance in a donor advised fund). Distributions to Type I or Type II supporting organizations may be qualifying distributions if not prohibited by regulations.[278] Distributions to the sponsoring organization generally are qualifying distributions; however, a distribution to the sponsoring organization in satisfaction of the ag-

[277] Applicable three-year periods for any donor advised fund run consecutively, such that the second three-year period begins immediately after the first three-year period ends. For example, assume donor advised fund X is established on March 30 of Year 1, and the sponsoring organization's taxable year corresponds to the calendar year. As of the end of Year 1, X has not been in existence for one full year; therefore, X's first applicable three-year period does not begin in Year 2. Instead, the first such period begins on January 1 of Year 3 and runs through December 31 of Year 5. X's second applicable three-year period begins on January 1 of Year 6 and ends on December 31 of Year 8.

[278] Regulations generally shall prohibit such a distribution where the donor or donor advisor of the amounts distributed directly or indirectly controls a supported organization of the Type I or Type II supporting organization.

gregate distribution requirement is a qualifying distribution only if the distribution is designated for use in connection with a charitable program of the sponsoring organization (e.g., if funds are transferred to a scholarship fund (that does not meet the definition of donor advised fund because, for example, the scholarship fund is not separately identified by reference to donors) for the awarding of scholarships consistent with the sponsoring organization's exempt purposes). Amounts permanently set aside for purposes, and under procedures similar to those, described in section 4942(g) are treated as qualifying distributions. Qualifying distributions also include amounts paid during a taxable year for reasonable and necessary administrative expenses charged to a donor advised fund by a sponsoring organization.

Valuation

Special valuation rules apply for purposes of determining the required distributable amount for a taxable year under the aggregate payout requirement and the account-level payout requirement applicable to accounts that hold illiquid assets. For such purposes, the fair market values of cash and of securities for which market quotations are readily available are determined on a monthly basis. All other assets ("illiquid assets") transferred by a donor to a sponsoring organization for maintenance in a donor advised fund are valued at the sum of (1) the value claimed by the donor for purposes of determining the donor's charitable deduction for the contribution of such assets to the sponsoring organization,[279] and (2) an assumed annual rate of return of five percent. If a donor advised fund purchases an illiquid asset, such asset is valued at the sum of (1) the purchase price paid for the assets, and (2) an assumed annual rate of return of five percent. The Secretary of the Treasury is authorized to specify the requirements for making such computations. Under the provision, the Secretary of the Treasury is also authorized to promulgate rules permitting adjustments in the value of an illiquid asset in situations where the asset declines significantly in value following a contribution or purchase of the asset.

Treatment of qualifying distributions

Distributions made in satisfaction of any of the above-described distribution requirements are counted for purposes of all payout requirements described in the provision. For purposes of any distribution requirement described in this provision, the taxpayer may designate a qualifying distribution as being made out of the undistributed amount remaining from any prior taxable year or as being made in satisfaction of the distribution requirement for the current taxable year. Amounts distributed in excess of the undistributed amount for the current year and all previous taxable years may be carried forward for up to five taxable years following the taxable year in which the excess payment is made.

[279] The donor is required to report to the sponsoring organization the value of the asset claimed by the donor for charitable deduction purposes either by supplying to the sponsoring organization a copy of the donor's completed Form 8283 related to the deduction (if applicable) or by following any alternative procedures specified by the Secretary.

Excise tax for failure to distribute

In the event of a failure to distribute the required amount in connection with any of the above-described distribution requirements within the prescribed time period, the provision imposes excise taxes similar to the private foundation excise taxes under section 4942. Specifically, a first-tier excise tax equal to 30 percent of the undistributed amount is imposed. If the failure is not corrected within the taxable period (as defined in existing section 4942(j)(1)), a second-tier tax equal to 100 percent of the undistributed amount is imposed. The first and second tier taxes are subject to abatement under generally applicable present law rules. Taxable period means, with respect to any undistributed amount for any taxable year or applicable 3-year period, the period beginning with the first day of the taxable year or applicable period and ending on the earlier of the date of mailing of a notice of deficiency with respect to the imposition of the initial tax or the date on which such tax is assessed.

Disqualified persons, excess benefit transactions, and other sanctions

Disqualified persons

The provision provides that donors, donor advisors, and investment advisors to donor advised funds (as well as persons related to the foregoing persons[280]) are treated as disqualified persons with respect to the sponsoring organization under section 4958 or under section 4946(a).

Excess benefit transactions

The provision also provides that distributions from a donor advised fund to a person that with respect to such fund is a donor, donor adviser, or a person related to a donor or donor adviser (though not an investment advisor) is treated as an excess benefit transaction under section 4958, with the entire amount paid to any such person treated as the amount of the excess benefit. This rule applies regardless of whether the sponsoring organization is a public charity or a private foundation and regardless of whether, but for this rule, the transaction would have been subject to the section 4941 self-dealing rules.[281]

Any amount repaid as a result of correcting such an excess benefit transaction shall not be held in or credited to any donor advised fund.

Other sanctions

Under the provision, distributions from a donor advised fund (as opposed to a sponsoring organization's non donor advised funds or accounts) to any person other than the sponsoring organization's

[280] For purposes of the provision, a person is treated as related to another person if (1) such person bears a relationship to such other person similar to the relationships described in sections 4958(f)(1)(B) and 4958(f)(1)(C).

[281] This rule includes any distribution to a donor, donor advisor, or a related person, whether in the form of a grant, loan, compensation arrangement, expense reimbursement, or other payment. If the excess benefit results from the payment of compensation, the entire amount paid as compensation will be deemed the amount of the excess benefit, whether the sponsoring organization is a private foundation or a public charity.

non donor advised funds or accounts or organizations described in section 170(b)(1)(A)[282] (other than Type III supporting organizations[283] or sponsoring organizations for maintenance in a donor advised fund) are prohibited.[284] The provision provides for a penalty in the event a distribution is made from a donor advised fund to an ineligible person, such as a private non-operating foundation or a Type III supporting organization. In the event of such a distribution, an excise tax equal to 20 percent of the amount of the distribution is imposed against any donor or donor advisor who advised that such distribution be made. In addition, an excise tax equal to five percent of the amount of the distribution is imposed against any manager of the sponsoring organization (defined in a manner similar to the term "foundation manager" under section 4945) who knowingly approved the distribution. The taxes described in this paragraph are subject to abatement under generally applicable present law rules.

Under the provision, if a donor, a donor advisor, or a person related to a donor or donor advisor of a donor advised fund advises as to a distribution that results in any such person receiving, directly or indirectly, a more than incidental benefit, excise taxes are imposed against any donor or donor advisor who advised as to the distribution, and against the recipient of the benefit. The amount of the tax is determined by multiplying the rate of the initial tax imposed against a disqualified person under section 4958 by the amount of the distribution that gave rise to the more-than-incidental benefit. Persons subject to the tax are jointly and severally liable for the entire amount of the tax. In addition, if a manager of the sponsoring organization (defined in a manner similar to the term "foundation manager" under section 4945) who agreed to the making of the distribution knowing that the distribution would confer a more than incidental benefit on a donor, a donor advisor, or a person related to a donor or donor advisor of a donor advised fund, the manager also is subject to an excise tax, calculated by multiplying the rate of the initial tax specified under section 4958 with respect to organization managers by the amount of the distribution that gave rise to the more than incidental benefit. The taxes on more than incidental benefit are subject to abatement under generally applicable present law rules.

Reporting and disclosure

The provision requires each sponsoring organization to disclose on its information return: (1) the total number of donor advised funds it owns; (2) the aggregate value of assets held in those funds at the end of the organization's taxable year; and (3) the aggregate

[282] By requiring that distributions from a donor advised fund be made only to certain entities, the provision prohibits distributions from a donor advised fund to a donor or donor advisor (or person related to a donor or donor advisor), whether as compensation, loans, or reimbursement of expenses.

[283] Distributions to Type I and Type II supporting organizations generally are not prohibited unless prohibited under regulations. Regulations generally shall prohibit such distributions where the donor or donor advisor of the amounts distributed directly or indirectly controls a supported organization of the Type I or Type II supporting organization.

[284] Under the provision, distributions from donor advised funds to individuals are prohibited. However, sponsoring organizations may make grants to individuals from amounts not held in donor advised funds and may establish scholarship funds that are not donor advised funds. A donor may choose to make a contribution directly to such a scholarship fund (or advise that a donor advised fund make a distribution to such a scholarship fund).

contributions to and grants made from those funds during the year. The statute of limitations for assessing any tax arising under the provision in any year with respect to which the required information has not been provided shall not expire before three years after the date on which the required information is disclosed to the IRS.

In addition, when seeking recognition of its tax-exempt status, a sponsoring organization must disclose whether it intends to maintain donor advised funds.

Effective date

The provision generally is effective for taxable years beginning after the date of enactment. Distribution requirements are effective for taxable years beginning after the date of enactment. Information return requirements are effective for taxable years ending after the date of enactment. The requirements concerning disclosures on an organization's application for tax exemption are effective for organizations applying for recognition of exempt status after the date of enactment. Requirements relating to charitable contributions to donor advised funds are effective for contributions made after 180 days from the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

15. Improve accountability of supporting organizations (secs. 241–246 of the Senate amendment and secs. 509, 4942, 4943, 4945, 4958, and 6033 and new sec. 4959 of the Code)

PRESENT LAW

Requirements for section 501(c)(3) tax-exempt status

Charitable organizations, i.e., organizations described in section 501(c)(3), generally are exempt from Federal income tax and are eligible to receive tax deductible contributions. A charitable organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.[285] In order to qualify as operating primarily for a purpose described in section 501(c)(3), an organization must satisfy the following operational requirements: (1) the net earnings of the organization may not inure to the benefit of any person in a position to influence the activities of the organization; (2) the organization must operate to provide a public benefit, not a private benefit;[286] (3) the organization may not be operated primarily to conduct an unrelated trade or business;[287] (4) the organization may not engage in substantial legislative lobbying; and (5) the organization may not participate or intervene in any political campaign.

[285] Treas. Reg. sec. 1.501(c)(3)–1(c)(1). The Code specifies such purposes as religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. In general, an organization is organized and operated for charitable purposes if it provides relief for the poor and distressed or the underprivileged. Treas. Reg. sec. 1.501(c)(3)–1(d)(2).

[286] Treas. Reg. sec. 1.501(c)(3)–1(d)(1)(ii).

[287] Treas. Reg. sec. 1.501(c)(3)–1(e)(1). Conducting a certain level of unrelated trade or business activity will not jeopardize tax-exempt status.

Section 501(c)(3) organizations (with certain exceptions) are required to seek formal recognition of tax-exempt status by filing an application with the IRS (Form 1023). In response to the application, the IRS issues a determination letter or ruling either recognizing the applicant as tax-exempt or not.

In general, organizations exempt from Federal income tax under section 501(a) are required to file an annual information return with the IRS.[288] Under present law, the information return requirement does not apply to several categories of exempt organizations. Organizations exempt from the filing requirement include organizations (other than private foundations), the gross receipts of which in each taxable year normally are not more than $25,000.[289]

Classification of section 501(c)(3) organizations

In general

Section 501(c)(3) organizations are classified either as "public charities" or "private foundations."[290] Private foundations generally are defined under section 509(a) as all organizations described in section 501(c)(3) other than an organization granted public charity status by reason of: (1) being a specified type of organization (i.e., churches, educational institutions, hospitals and certain other medical organizations, certain organizations providing assistance to colleges and universities, or a governmental unit); (2) receiving a substantial part of its support from governmental units or direct or indirect contributions from the general public; or (3) providing support to another section 501(c)(3) entity that is not a private foundation. In contrast to public charities, private foundations generally are funded from a limited number of sources (e.g., an individual, family, or corporation). Donors to private foundations and persons related to such donors together often control the operations of private foundations.

Because private foundations receive support from, and typically are controlled by, a small number of supporters, private foundations are subject to a number of anti-abuse rules and excise taxes not applicable to public charities.[291] For example, the Code imposes excise taxes on acts of "self-dealing" between disqualified persons (generally, an enumerated class of foundation insiders[292]) and a private foundation. Acts of self-dealing include, for example, sales or exchanges, or leasing, of property; lending of money; or the furnishing of goods, services, or facilities between a disqualified person and a private foundation.[293] In addition, private non-operating foundations are required to pay out a minimum amount each

[288] Sec. 6033(a)(1).

[289] Sec. 6033(a)(2); Treas. Reg. sec. 1.6033–2(a)(2)(i); Treas. Reg. sec. 1.6033–2(g)(1). Sec. 6033(a)(2)(A)(ii) provides a $5,000 annual gross receipts exception from the annual reporting requirements for certain exempt organizations. In Announcement 82–88, 1982–25 I.R.B. 23, the IRS exercised its discretionary authority under section 6033 to increase the gross receipts exception to $25,000, and enlarge the category of exempt organizations that are not required to file Form 990.

[290] Sec. 509(a). Private foundations are either private operating foundations or private non-operating foundations. In general, private operating foundations operate their own charitable programs in contrast to private non-operating foundations, which generally are grant-making organizations. Most private foundations are non-operating foundations.

[291] Secs. 4940–4945.

[292] See sec. 4946(a).

[293] Sec. 4941.

year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization's exempt purposes, including reasonable and necessary administrative expenses.[294] Certain expenditures of private foundations are also subject to tax.[295] In general, taxable expenditures are expenditures: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility[296] with respect to the grant; or (5) for any non-charitable purpose. Additional excise taxes may apply in the event a private foundation holds certain business interests ("excess business holdings")[297] or makes an investment that jeopardizes the foundation's exempt purposes.[298]

Public charities also enjoy certain advantages over private foundations regarding the deductibility of contributions. For example, contributions of appreciated capital gain property to a private foundation generally are deductible only to the extent of the donor's cost basis.[299] In contrast, contributions to public charities generally are deductible in an amount equal to the property's fair market value, except for gifts of inventory and other ordinary income property, short-term capital gain property, and tangible personal property the use of which is unrelated to the donee organization's exempt purpose. In addition, under present law, a taxpayer's deductible contributions generally are limited to specified percentages of the taxpayer's contribution base, which generally is the taxpayer's adjusted gross income for a taxable year. The applicable percentage limitations vary depending upon the type of property contributed and the classification of the donee organization. In general, contributions to non-operating private foundations are limited to a smaller percentage of the donor's contribution base (up to 30 percent) than contributions to public charities (up to 50 percent).[300]

Supporting organizations (section 509(a)(3))

The Code provides that certain "supporting organizations" (in general, organizations that provide support to another section 501(c)(3) organization that is not a private foundation) are classified as public charities rather than private foundations.[301] To qualify as a supporting organization, an organization must meet all three of the following tests: (1) it must be organized and at all

[294] Sec. 4942(g)(1)(A). A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's exempt purposes and certain amounts set-aside for exempt purposes. Sec. 4942(g)(1)(B) and 4942(g)(2).

[295] Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[296] In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

[297] Sec. 4943.

[298] Sec. 4944.

[299] A special rule in section 170(e)(5) provides that taxpayers are allowed a deduction equal to the fair market value of certain contributions of appreciated, publicly traded stock contributed to a private foundation.

[300] Sec. 170(b).

[301] Sec. 509(a)(3).

times operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more "publicly supported organizations"[302] (the "organizational and operational tests");[303] (2) it must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations (the "relationship test");[304] and (3) it must not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations (the "lack of outside control test").[305]

To satisfy the relationship test, a supporting organization must hold one of three statutorily described close relationships with the supported organization. The organization must be: (1) operated, supervised, or controlled by a publicly supported organization (commonly referred to as "Type I" supporting organizations); (2) supervised or controlled in connection with a publicly supported organization ("Type II" supporting organizations); or (3) operated in connection with a publicly supported organization ("Type III" supporting organizations).[306]

Type I supporting organizations

In the case of supporting organizations that are operated, supervised, or controlled by one or more publicly supported organizations (Type I supporting organizations), one or more supported organizations must exercise a substantial degree of direction over the policies, programs, and activities of the supporting organization.[307] The relationship between the Type I supporting organization and the supported organization generally is comparable to that of a parent and subsidiary. The requisite relationship may be established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.[308]

Type II supporting organizations

Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations. Rather than the parent-subsidiary relationship characteristic of Type I organizations, the relationship between a Type II organization and its supported organizations is more analogous to a brother-sister relationship. In order to satisfy the Type II relationship requirement, generally there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations.[309] An organization generally is not considered to be "supervised or controlled in connection with" a publicly supported organization merely be-

[302] In general, supported organizations of a supporting organization must be publicly supported charities described in sections 509(a)(1) or (a)(2).
[303] Sec. 509(a)(3)(A).
[304] Sec. 509(a)(3)(B).
[305] Sec. 509(a)(3)(C).
[306] Treas. Reg. sec. 1.509(a)–4(f)(2).
[307] Treas. Reg. sec. 1.509(a)–4(g)(1)(i).
[308] Id.
[309] Treas. Reg. sec. 1.509(a)–4(h)(1).

cause the supporting organization makes payments to the publicly supported organization, even if the obligation to make payments is enforceable under state law.[310]

Type III supporting organizations

Type III supporting organizations are "operated in connection with" one or more publicly supported organizations. To satisfy the "operated in connection with" relationship, Treasury regulations require that the supporting organization be responsive to, and significantly involved in the operations of, the publicly supported organization. This relationship is deemed to exist where the supporting organization meets both a "responsiveness test" and an "integral part test."[311]

In general, the responsiveness test requires that the Type III supporting organization be responsive to the needs or demands of the publicly supported organizations. The responsiveness test may be satisfied in one of two ways.[312] First, the supporting organization may demonstrate that: (1)(a) one or more of its officers, directors, or trustees are elected or appointed by the officers, directors, trustees, or membership of the supported organization; (b) one or more members of the governing bodies of the publicly supported organizations are also officers, directors, or trustees of the supporting organization; or (c) the officers, directors, or trustees of the supporting organization maintain a close continuous working relationship with the officers, directors, or trustees of the publicly supported organizations; and (2) by reason of such arrangement, the officers, directors, or trustees of the supported organization have a significant voice in the investment policies of the supporting organization, the timing and manner of making grants, the selection of grant recipients by the supporting organization, and otherwise directing the use of the income or assets of the supporting organization.[313] Alternatively, the responsiveness test may be satisfied if the supporting organization is a charitable trust under state law, each specified supported organization is a named beneficiary under the trust's governing instrument, and the beneficiary organization has the power to enforce the trust and compel an accounting under state law.[314]

In general, the integral part test requires that the Type III supporting organization maintain significant involvement in the operations of one or more publicly supported organizations, and that such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides. There are two alternative methods for satisfying the integral part test. The first alternative is to establish that (1) the activities engaged in for or on behalf of the publicly supported organization are activities to perform the functions of, or carry out the purposes of, such organizations; and (2) these activities, but for the

[310] Treas. Reg. sec. 1.509(a)–4(h)(2).
[311] Treas. Reg. sec. 1.509(a)–4(i)(1).
[312] For an organization that was supporting or benefiting one or more publicly supported organizations before November 20, 1970, additional facts and circumstances, such as an historic and continuing relationship between organizations, also may be taken into consideration to establish compliance with either of the responsiveness tests. Treas. Reg. sec. 1.509(a)–4(i)(1)(ii).
[313] Treas. Reg. sec. 1.509(a)–4(i)(2)(ii).
[314] Treas. Reg. sec. 1.509(a)–4(i)(2)(iii).

involvement of the supporting organization, normally would be engaged in by the publicly supported organizations themselves.[315] The second method for satisfying the integral part test is to establish that: (1) the supporting organization pays substantially all of its income to or for the use of one or more publicly supported organizations;[316] (2) the amount of support received by one or more of the publicly supported organizations is sufficient to insure the attentiveness of the organization or organizations to the operations of the supporting organization (this is known as the "attentiveness requirement");[317] and (3) a significant amount of the total support of the supporting organization goes to those publicly supported organizations that meet the attentiveness requirement.[318]

Intermediate sanctions (excess benefit transaction tax)

The Code imposes excise taxes on excess benefit transactions between disqualified persons and public charities.[319] An excess benefit transaction generally is a transaction in which an economic benefit is provided by a public charity directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

For purposes of the excess benefit transaction rules, a disqualified person is any person in a position to exercise substantial influence over the affairs of the public charity at any time in the five-year period ending on the date of the transaction at issue.[320] Persons holding certain powers, responsibilities, or interests (e.g., officers, directors, or trustees) are considered to be in a position to exercise substantial influence over the affairs of the public charity.

An excess benefit transaction tax is imposed on the disqualified person and, in certain cases, on the organization managers, but is not imposed on the public charity. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected within a specified period. A tax of 10 percent of the excess benefit (not to exceed $10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.

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[315] Treas. Reg. sec. 1.509(a)–4(i)(3)(ii).

[316] For this purpose, the IRS has defined the term "substantially all" of an organization's income to mean 85 percent or more. Rev. Rul. 76–208, 1976–1 C.B. 161.

[317] Although the regulations do not specify the requisite level of support in numerical or percentage terms, the IRS has suggested that grants that represent less than 10 percent of the beneficiary's support likely would be viewed as insufficient to ensure attentiveness. Gen. Couns. Mem. 36379 (August 15, 1975). As an alternative to satisfying the attentiveness standard by the foregoing method, a supporting organization may demonstrate attentiveness by showing that, in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. Treas. Reg. sec. 1.509(a)–4(i)(3)(iii)(b).

[318] Treas. Reg. sec. 1.509(a)–4(i)(3)(iii).

[319] Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status. The tax also applies to transactions between disqualified persons and social welfare organizations (as described in section 501(c)(4)).

[320] Sec. 4958(f)(1). A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons.

HOUSE BILL

No provision.

SENATE AMENDMENT

Provisions relating to all (Type I, Type II, and Type III) supporting organizations

Excess benefit transactions

Under the provision, if a supporting organization (Type I, Type II, or Type III) makes a grant, loan, payment of compensation, or other similar payment to a substantial contributor (or person related to the substantial contributor) of the supporting organization, for purposes of the excess benefit transaction rules (sec. 4958), the substantial contributor is treated as a disqualified person and the payment is treated as an excess benefit transaction with the entire amount of the payment treated as the excess benefit.

A substantial contributor means any person who contributed or bequeathed an aggregate amount of more than $5,000 to the organization, if such amount is more than two percent of the total contributions and bequests received by the organization before the close of the taxable year of the organization in which the contribution or bequest is received by the organization from such person. In the case of a trust, a substantial contributor also includes the creator of the trust. A substantial contributor does not include a public charity (other than a supporting organization).

A person is a related person ("related person") if a person is a member of the family (determined under section 4958(f)(4)) of a substantial contributor, or a 35 percent entity, defined as a corporation, partnership, trust, or estate in which a substantial contributor or family member thereof own more than 35 percent of the total combined voting power, profits interest, or beneficial interest, as the case may be.

In addition, under the provision, loans by any supporting organization (Type I, Type II, or Type III) to a disqualified person (as defined in section 4958) of the supporting organization are treated as an excess benefit transaction under section 4958 and the entire amount of the loan is treated as an excess benefit. For this purpose, a disqualified person does not include a public charity (other than a supporting organization).

Disclosure requirements

All supporting organizations are required to file an annual information return (Form 990 series) with the Secretary, regardless of the organization's gross receipts. A supporting organization must indicate on such annual information return whether it is a Type I, Type II, or Type III supporting organization and must identify its supported organizations.

Supporting organizations must demonstrate annually that the organization is not controlled directly or indirectly by one or more disqualified persons (other than foundation managers and other than one or more publicly supported organizations) through a certification on the annual information return.

Disqualified person

For purposes of the excess benefit transaction rules (sec. 4958), a disqualified person of a supporting organization is treated as a disqualified person of the supported organization.

Provisions that apply to Type III supporting organizations

Modify payout requirement of Type III supporting organizations

A Type III supporting organization must pay each taxable year, to or for the use of one or more public charities described in section 509(a)(1) or 509(a)(2) ("qualifying distributions"), the sum of (1) the greater of (i) 85 percent of its adjusted net income (as defined in section 4942(f)) for the preceding taxable year or (ii) the applicable percentage[321] of the aggregate fair market value of all of the assets of the organization other than assets that are used (or held for use) directly in supporting the charitable programs of the supporting organization or one or more supported organizations, determined as of the last day of the preceding taxable year, and (2) any amount received or accrued in such year as repayments of amounts that were taken into account as support provided by the supporting organization in prior years. Qualifying distributions are treated as made first to satisfy the pay out requirement of the immediately preceding taxable year, and then of the taxable year, unless the taxpayer elects to have an amount as satisfying the payout of any prior taxable year. Amounts distributed in excess of the required payout for the current year and all previous taxable years may be carried forward for up to five taxable years following the taxable year in which the excess payment is made.

A supporting organization's administrative expenses count as expenses to or for the use of a supported organization. The holding of assets for investment purposes, or to operate an unrelated trade or business, is not considered a use or holding for use directly to support a supported organization's charitable programs. The Secretary may provide guidance as to types of uses of assets that are considered to be directly in support of a supported organization's charitable programs similar to guidance provided under Treasury Regulation section 53.4942(a)–2(c)(3)(i).

An organization that fails to meet the payout requirement is subject to an initial tax of 30 percent of the unpaid amount, increased to 100 percent of the unpaid amount if the payout requirement is not met by the earlier of the date of mailing of a notice of deficiency with respect to the initial tax or the date on which the initial tax is assessed.

Excess business holdings

The excess business holdings rules of section 4943 are applied to Type III supporting organizations. In applying such rules, the term disqualified person has the meaning provided in section 4958, and also includes substantial contributors and related persons and any organization that is effectively controlled by the same person

[321] The percentage is three percent for the first taxable year beginning after the date of enactment, four percent for the second such taxable year, and five percent for any such taxable year thereafter.

or persons who control the supporting organization or any organization substantially all of the contributions to which were made by the same person or persons who made substantially all of the contributions to the supporting organization. The excess business holdings rules do not apply if the holdings are held for the benefit of the community pursuant to the direction of a State attorney general or a State official with jurisdiction over the Type III supporting organization. The Secretary has the authority not to impose the excess business holding rules if the organization establishes to the satisfaction of the Secretary that the excess holdings are consistent with the exempt purposes of the organization. Transition rules apply to the present holdings of an organization similar to those of section 4943(c)(4)–(6).

The excess business holdings rules also apply to Type II supporting organizations but only if such organization accepts any gift or contribution from a person (other than a public charity, not including a supporting organization) who (1) controls, directly or indirectly, either alone or together (with persons described below) the governing body of a supported organization of the supporting organization; (2) is a member of the family of such a person; or (3) is a 35 percent controlled entity.

Organizational and operational requirements

In general, after the date of enactment of the provision, a Type III supporting organization may not support more than five organizations. A transition rule applies to Type III supporting organizations that support more than five organizations on such date. Such organizations are not required to reduce the number of supported organizations, but may not increase the number of organizations supported above the number of organizations supported on the date of enactment, and may not add new supported organizations as beneficiaries unless no more than five organizations are supported by the supporting organization following such addition.

A Type III supporting organization may not support an organization that is not organized in the United States on any date after the date which is 180 days after the date of enactment,[322] and may not be a donor with respect to a donor advised fund.

Relationship to supported organization(s)

A Type III supporting organization must, as part of its exemption application (Form 1023) attach a letter from each supported organization acknowledging that the supported organization has been designated by such organization as a supported organization.

On the annual information return filed by a Type III supporting organization, the organization must indicate that it has obtained letters from organizations that received its support. It is intended that all such letters must be signed by a senior officer or a member of the Board of the supported organization. The letters must show (1) that the supported organization agrees to be sup-

[322] U.S. charities established principally to provide financial and other assistance to a foreign charity, sometimes referred to as "friends of" organizations, may not be established as supporting organizations under the provision. Such organizations may continue to obtain public charity status, however, by virtue of demonstrating broad public support (as described in sections 509(a)(1) and 509(a)(2)).

ported by the supporting organization, (2) the type of support provided or to be provided, and (3) how such support furthers the supported organization's charitable purposes.

A Type III supporting organization must apprise each organization it supports of information regarding the supporting organization in order to help ensure the supporting organization's responsiveness. Such a showing could be satisfied, for example, through provision of documentation such as a copy of the supporting organization's governing documents, any changes made to the governing documents, the organization's annual information return filed with the Secretary (Form 990 series), any tax return (Form 990–T) filed with the Secretary, and an annual report (including a description of all of the support provided by the supporting organization, how such support was calculated, and a projection of the next year's support). Failure to make a sufficient showing is a factor in determining whether the responsiveness test of present law is met.

A Type III supporting organization that is organized as a trust must, in addition to present law requirements, establish to the satisfaction of the Secretary, that it has a close and continuous relationship with the supported organization such that the trust is responsive to the needs or demands of the supported organization.

Other provisions

Under the provision, if a Type I or Type III supporting organization accepts any gift or contribution from a person (other than a public charity, not including a supporting organization) who (1) controls, directly or indirectly, either alone or together (with persons described below) the governing body of a supported organization of the supporting organization; (2) is a member of the family of such a person; or (3) is a 35 percent controlled entity, then the supporting organization is treated as a private foundation for all purposes until such time as the organization can demonstrate to the satisfaction of the Secretary that it qualifies as a public charity other than as a supporting organization.

Under the provision, a non-operating private foundation may not count as a qualifying distribution under section 4942 any amount paid to a supporting organization. In addition, any such amount is treated as a taxable expenditure under section 4945.

Effective date

The provision generally is effective on the date of enactment. The distribution requirements are effective for taxable years beginning after the date of enactment. The prohibited transaction rules are effective for transactions occurring after the date of enactment. The excess business holdings requirements are effective for taxable years beginning after the date of enactment. The provision relating to distributions by nonoperating private foundations is effective for distributions and expenditures made after the date of enactment. The return requirements are effective for returns filed for taxable years ending after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

TITLE IV—MISCELLANEOUS PROVISIONS

A. RESTRUCTURE NEW YORK LIBERTY ZONE TAX INCENTIVES

(Sec. 301 of the Senate amendment)

PRESENT LAW

In general

Present law includes a number of incentives to invest in property located in the New York Liberty Zone ("NYLZ"), which is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York. These incentives were enacted following the terrorist attack in New York City on September 11, 2001.[323]

Special depreciation allowance for qualified New York Liberty Zone property

Section 1400L(b) allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified NYLZ property.[324] In order to qualify, property generally must be placed in service on or before December 31, 2006 (December 31, 2009 in the case of nonresidential real property and residential rental property).

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be property to which the general rules of the Modified Accelerated Cost Recovery System ("MACRS")[325] apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) certain nonresidential real property and residential rental property, or (4) computer software other than computer software covered by section 197. A special rule precludes the additional first-year depreciation under this provision for (1) qualified NYLZ leasehold improvement property[326] and (2) property eligible for the additional first-year depreciation deduction under section 168(k) (i.e., property is eligible for only one 30 percent additional first-

[323] In addition to the NYLZ provisions described above, other NYLZ incentives are provided: (1) $8 billion of tax-exempt private activity bond financing for certain nonresidential real property, residential rental property and public utility property is authorized to be issued after March 9, 2002, and before January 1, 2010; and (2) $9 billion of additional tax-exempt advance refunding bonds is available after March 9, 2002, and before January 1, 2006, with respect to certain State or local bonds outstanding on September 11, 2001.

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

[325] A special rule precludes the additional first-year depreciation deduction for property that is required to be depreciated under the alternative depreciation system of MACRS.

[326] Qualified NYLZ leasehold improvement property is defined in another provision. Leasehold improvements that do not satisfy the requirements to be treated as "qualified NYLZ leasehold improvement property" maybe eligible for the 30 percent additional first-year depreciation deduction (assuming all other conditions are met).

year depreciation). Second, substantially all of the use of such property must be in the NYLZ. Third, the original use of the property in the NYLZ must commence with the taxpayer on or after September 11, 2001. Finally, the property must be acquired by purchase[327] by the taxpayer after September 10, 2001 and placed in service on or before December 31, 2006. For qualifying nonresidential real property and residential rental property the property must be placed in service on or before December 31, 2009 in lieu of December 31, 2006. Property will not qualify if a binding written contract for the acquisition of such property was in effect before September 11, 2001.[328]

Nonresidential real property and residential rental property is eligible for the additional first-year depreciation only to the extent such property rehabilitates real property damaged, or replaces real property destroyed or condemned as a result of the terrorist attacks of September 11, 2001.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies for the additional first-year depreciation deduction if the taxpayer begins the manufacture, construction, or production of the property after September 10, 2001, and the property is placed in service on or before December 31, 2006[329] (and all other requirements are met). Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Depreciation of New York Liberty Zone leasehold improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease.[330] This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service.[331] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement is placed in service.[332]

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

[328] Property is not precluded from qualifying for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to September 11, 2001.

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

[330] Sec. 168(i)(8). The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System ("ACRS") to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Tax Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The Tax Reform Act of 1986 also denied the use of component depreciation under MACRS.

[331] Former sections 168(f)(6) and 178 provided that, in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. The Tax Reform Act of 1986 repealed these provisions.

[332] Secs. 168(b)(3), (c), (d)(2), and (i)(6). If the improvement is characterized as tangible personal property, ACRS or MACRS depreciation is calculated using the shorter recovery periods, accelerated methods, and conventions applicable to such property. The determination of whether improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a "structural component" of a building (as defined by Treas. Reg. sec. 1.48–1(e)(1)). See, e.g., Metro National Corp v. Commissioner, 52 TCM (CCH) 1440 (1987); King Radio Corp Inc. v. U.S., 486 F.2d 1091 (10th Cir.

A special rule exists for qualified NYLZ leasehold improvement property, which is recovered over five years using the straight-line method. The term qualified NYLZ leasehold improvement property means property defined in section 168(e)(6) that is acquired and placed in service after September 10, 2001, and before January 1, 2007 (and not subject to a binding contract on September 10, 2001), in the NYLZ. For purposes of the alternative depreciation system, the property is assigned a nine-year recovery period. A taxpayer may elect out of the 5-year (and 9-year) recovery period for qualified NYLZ leasehold improvement property.

Increased section 179 expensing for qualified New York Liberty Zone property

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct the cost of qualifying property. For taxable years beginning in 2003 through 2007, a taxpayer may deduct up to $100,000 of the cost of qualifying property placed in service for the taxable year. In general, qualifying property for this purpose is defined as depreciable tangible personal property (and certain computer software) 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. The $100,000 and $400,000 amounts are indexed for inflation.

For taxable years beginning in 2008 and thereafter, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In general, qualifying property for this purpose is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

The amount a taxpayer can deduct under section 179 is increased for qualifying property used in the NYLZ. Specifically, the maximum dollar amount that may be deducted under section 179 is increased by the lesser of (1) $35,000 or (2) the cost of qualifying property placed in service during the taxable year. This amount is in addition to the amount otherwise deductible under section 179.

Qualifying property for purposes of the NYLZ provision means section 179 property[333] purchased and placed in service by the tax-

1973); Mallinckrodt, Inc. v. Commissioner, 778 F.2d 402 (8th Cir. 1985) (with respect to various leasehold improvements).

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

payer after September 10, 2001 and before January 1, 2007, where (1) substantially all of the use of such property is in the NYLZ in the active conduct of a trade or business by the taxpayer in the NYLZ, and (2) the original use of which in the NYLZ commences with the taxpayer after September 10, 2001.[334]

The phase-out range for the section 179 deduction attributable to NYLZ property is applied by taking into account only 50 percent of the cost of NYLZ property that is section 179 property. Also, no general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

The provision is effective for property placed in service after September 10, 2001 and before January 1, 2007.

Extended replacement period for New York Liberty Zone involuntary conversions

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period (the "replacement period") property similar or related in service or use (section 1033). If the taxpayer does not replace the converted property with property similar or related in service or use, then gain generally is recognized. If the taxpayer elects to apply the rules of section 1033, gain on the converted property is recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property. In general, the replacement period begins with the date of the disposition of the converted property and ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized.[335] The replacement period is extended to three years if the converted property is real property held for the productive use in a trade or business or for investment.[336]

The replacement period is extended to five years with respect to property that was involuntarily converted within the NYLZ as a result of the terrorist attacks that occurred on September 11, 2001. However, the five-year period is available only if substantially all of the use of the replacement property is in New York City. In all other cases, the present-law replacement period rules continue to apply.

HOUSE BILL

No provision.

SENATE AMENDMENT

Repeal of certain NYLZ incentives

The provision repeals the four NYLZ incentives relating to the additional first-year depreciation allowance of 30 percent, the five-year depreciation of leasehold improvements, the additional section

[334] See Rev. Proc. 2002–33, 2002–20 I.R.B. 963 (May 20, 2002), for procedures on claiming the increased section 179 expensing deduction by taxpayers who filed their tax returns before June 1, 2002.

[335] Section 1033(a)(2)(B).

[336] Section 1033(g)(4).

179 expensing, and the extended replacement period for involuntary conversions.[337]

Creation of New York Liberty Zone tax credits

The provision provides a credit against tax imposed (other than taxes of section 3111(a), 3403, or subtitle D) paid or incurred by any governmental unit of the State of New York and the City of New York equal to the lesser of (1) the total expenditures during such year by such governmental unit for qualifying projects, or (2) the amount allocated to such governmental unit for such calendar year.

Qualifying projects means any transportation infrastructure project, including highways, mass transit systems, railroads, airports, ports, and waterways, in or connecting with the New York Liberty Zone, which is designated as a qualifying project jointly by the Governor of the State of New York and the Mayor of the City of New York.

The Governor of the State of New York and the Mayor of the City of New York shall jointly allocate to a governmental unit the amount of expenditures which may be taken into account for purposes of the credit for any calendar year in the credit period with respect to a qualifying project. The aggregate limit that may be allocated for all calendar years in the credit period is two billion dollars. The annual limit for any calendar year in the credit period shall not exceed the sum of 200 million dollars plus the aggregate amount authorized to be allocated for all preceding calendar years in the credit period which was not allocated. The credit period is the ten-year period beginning on January 1, 2006.

If, at the close of the credit period, the aggregate amounts allocated are less than the 2 billion dollar aggregate limit, the Governor of the State of New York and the Mayor of the City of New York may jointly allocate, for any calendar year following the credit period, for expenditures with respect to qualifying projects, amounts that in sum for all years following the credit period would equal such shortfall.

Under the provision, any expenditure for a qualifying project taken into account for purposes of the credit shall be considered State and local funds for the purpose of any Federal program.

Effective date

The provision is effective on the date of enactment, with an exception for property subject to a written binding contract in effect on the date of enactment which is placed in service prior to the original sunset dates under present law. The extended replacement period for involuntarily converted property ends on the earlier of (1) the date of enactment or (2) the last day of the five-year period specified in the Jobs Creation and Worker Assistance Act of 2002 ("JCWAA").[338]

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[337] The provision does not change the present-law rules relating to certain NYLZ private activity bond financing and additional advance refunding bonds.

[338] Pub. L. No. 107–147, sec. 301 (2002).

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

B. Modification of S Corporation Passive Investment Income Rules

(Sec. 302 of the Senate amendment and secs. 1362 and 1375 of the Code)

PRESENT LAW

An S corporation is subject to corporate-level tax, at the highest corporate tax rate, on its excess net passive income if the corporation has (1) accumulated earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

Excess net passive income is the net passive income for a taxable year multiplied by a fraction, the numerator of which is the amount of passive investment income in excess of 25 percent of gross receipts and the denominator of which is the passive investment income for the year. Net passive income is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of that income. Passive investment income generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). Passive investment income generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, or gain or loss from any section 1256 contract (or related property) of an options or commodities dealer.

In addition, an S corporation election is terminated whenever the S corporation has accumulated earnings and profits at the close of each of three consecutive taxable years and has gross receipts for each of those years more than 25 percent of which are passive investment income.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment increases the 25-percent threshold to 60 percent; eliminates gains from the sale or exchange of stock or securities from the definition of passive investment income; and eliminates the rule terminating an S election by reason of having excess passive investment income for three consecutive taxable years.

Effective date.—The provision applies to taxable years beginning after December 31, 2006, and before October 1, 2009.

CONFERENCE AGREEMENT

The conference agreement does not contain the Senate amendment provision.

C. Capital Expenditure Limitation for Qualified Small Issue Bonds

(Sec. 303 of the Senate amendment and sec. 144 of the Code)

PRESENT LAW

Qualified small-issue bonds are tax-exempt State and local government bonds used to finance private business manufacturing facilities (including certain directly related and ancillary facilities) or the acquisition of land and equipment by certain farmers. In both instances, these bonds are subject to limits on the amount of financing that may be provided, both for a single borrowing and in the aggregate. In general, no more than $1 million of small-issue bond financing may be outstanding at any time for property of a business (including related parties) located in the same municipality or county. Generally, this $1 million limit may be increased to $10 million if all other capital expenditures of the business in the same municipality or county are counted toward the limit over a six-year period that begins three years before the issue date of the bonds and ends three years after such date. Outstanding aggregate borrowing is limited to $40 million per borrower (including related parties) regardless of where the property is located.

For bonds issued after September 30, 2009, the Code permits up to $10 million of capital expenditures to be disregarded, in effect increasing from $10 million to $20 million the maximum allowable amount of total capital expenditures by an eligible business in the same municipality or county.[339] However, no more than $10 million of bond financing may be outstanding at any time for property of an eligible business (including related parties) located in the same municipality or county. Other limits (e.g., the $40 million per borrower limit) also continue to apply.

HOUSE BILL

No provision.

SENATE AMENDMENT

The provision accelerates the application of the $20 million capital expenditure limitation from bonds issued after September 30, 2009, to bonds issued after December 31, 2006.

Effective date.—The provision is effective on the date of enactment for bonds issued after December 31, 2006.

CONFERENCE AGREEMENT

The conference agreement includes the Senate amendment provision.

[339] Sec. 144(a)(4)(G) as added by sec. 340(a) of the American Jobs Creation Act of 2004, Pub. L. No. 108–357 (2004).

D. Premiums for Mortgage Insurance

(Sec. 304 of the Senate amendment and secs. 163(h) and 6050H 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.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment 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 Senate amendment 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).

Reporting rules apply under the provision.

Effective date.—The Senate amendment provision is effective for amounts paid or accrued in taxable years beginning after December 31, 2006, and ending before January 1, 2008, and properly allocable to that period, with respect to mortgage insurance contracts issued after December 31, 2006.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

E. Sense of the Senate on Use of No-Bid Contracting by Federal Emergency Management Agency

(Sec. 305 of the Senate amendment)

PRESENT LAW

Present law does not provide for the special rules contemplated in the Sense of the Senate provision described below.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate Amendment provision provides that it is the sense of the Senate that the Federal Emergency Management Agency should (1) rebid certain contracts entered into following Hurricane Katrina for which competing bids were not solicited; (2) implement its planned competitive contracting strategy and, in carrying out that strategy, prioritize local and small disadvantaged businesses in contracting and subcontracting; and (3) immediately after awarding any contract, make public the dollar amount of the contract and whether competing bids were solicited.

Effective date.—The Senate amendment provision is effective upon enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

F. Sense of Congress Regarding Doha Round

(Sec. 306 of the Senate amendment)

PRESENT LAW

Present law does not provide a sense of Congress regarding the Doha Round of trade negotiations.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment provision provides that it is the sense of Congress that the United States should not be a signatory to an agreement or protocol with respect to the Doha Development

Round of the World Trade Organization (WTO) negotiations or any other bilateral or multilateral trade negotiations if the agreement or protocol (1) adopts any provision to lessen the effectiveness of domestic and international disciplines on unfair trade or safeguard provisions or (2) would lessen in any manner the ability of the United States to enforce rigorously its trade laws, including the antidumping, countervailing duty, and safeguard laws. The provision also provides that it is the sense of Congress that (1) the United States trade laws and international rules appropriately serve the public interest by offsetting injurious unfair trade, and that further balancing modifications or other similar provisions are unnecessary and would add to the complexity and difficulty of achieving relief against injurious unfair trade practices, and (2) the United States should ensure that any new agreement relating to international disciplines on unfair trade or safeguard provisions fully rectifies and corrects decisions by WTO dispute settlement panels or the Appellate Body that have unjustifiably and negatively impacted, or threaten to negatively impact, United States law or practice, including a law or practice with respect to foreign dumping or subsidization.

Effective date.—The Senate amendment provision is effective upon enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

G. Treatment of Certain Stock Option Plans Under Nonqualified Deferred Compensation Rules

(Sec. 308 of the Senate amendment)

PRESENT LAW

Amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied.[340] For example, distributions from a nonqualified deferred compensation plan may be allowed only upon certain times and events. Rules also apply for the timing of elections. If the requirements are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.

The rules governing the tax treatment of nonqualified deferred compensation generally apply to stock options granted to employees. However, exceptions apply to incentive stock options and options granted under employee stock purchase plans.[341]

[340] Section 409A.
[341] Sections 422 and 423, respectively.

HOUSE BILL

No provision.

SENATE AMENDMENT

Under the Senate amendment, the Secretary of the Treasury is directed to modify the regulations relating to nonqualified deferred compensation to extend to applicable foreign option plans the exceptions for incentive stock options and options granted under employee stock purchase plans. The exception for applicable foreign option plans is subject to such terms and conditions as may be prescribed in the regulations.

An applicable foreign option plan means a plan that (1) provides for the issuance of employee stock options; (2) is established under the laws of a foreign jurisdiction; and (3) under such laws or the terms of the plan (or both), is subject to requirements substantially similar to the requirements applicable to incentive stock options and options granted under employee stock purchase plans.

For this purpose, a foreign option plan is not treated as subject to requirements substantially similar to the requirements applicable to incentive stock options and options granted under employee stock purchase plans unless the foreign option plan: (1) is required to cover substantially all employees; (2) in the case of an option under an employee stock purchase plan, is required to provide an option price of not less than the lesser of not less than 80 percent of the fair market value of the stock at the time the option is granted or an amount which, under the terms of the option, cannot be less than 80 percent of the fair market value of the stock at the time the option is exercised; (3) is required to provide coverage of individuals who, but for the exception under the provision, would be subject to tax under the nonqualified deferred compensation rules with respect to the plan; and (4) meets such other requirements as prescribed in regulations issued under the provision.

Effective date.—The provision is effective on the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

H. Sense of the Senate Regarding the Dedication of Excess Funds

(Sec. 309 of the Senate amendment)

PRESENT LAW

Present law does not provide a sense of the Senate regarding the dedication of Treasury revenues that exceed amounts specified in the reconciliation instructions for this bill.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment provides that it is the sense of the Senate that any Federal revenue increases resulting from the Senate amendment and exceeding the amounts specified in applicable reconciliation instructions are to be dedicated to the Low-Income Home Energy Assistance Program. The amount so dedicated is not to exceed by more than $2.9 billion the funding level established for the program for fiscal year 2005.

Effective date.—The Senate amendment provision is effective upon enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

I. Modification of Treatment of Loans to Qualified Continuing Care Facilities

(Sec. 310 of the Senate amendment and sec. 7872(g) of the Code)

PRESENT LAW

Present law provides generally that certain loans that bear interest at a below-market rate are treated as loans bearing interest at the market rate, accompanied by imputed payments characterized in accordance with the substance of the transaction (for example, as a gift, compensation, a dividend, or interest).[342]

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.[343]

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).[344]

For this purpose, a continuing care contract means a written contract between an individual and a qualified continuing care facility under which: (1) the individual or the individual's spouse may use a qualified continuing care facility for their life or lives; (2) the individual or the individual's spouse will first reside in a separate, independent living unit with additional facilities outside such unit for the providing of meals and other personal care and will not require long-term nursing care, and then will be provided long-term and skilled nursing care as the health of the individual or the individual's spouse requires; and (3) no additional substantial payment is required if the individual or the individual's spouse requires increased personal care services or long-term and skilled nursing care.

For this purpose, a qualified continuing care facility means one or more facilities that are designed to provide services under continuing care contracts, and substantially all of the residents of

[342] Sec. 7872.
[343] Sec. 7872(g).
[344] Rev. Rul. 2005–75, 2005–49 I.R.B. 1073.

which are covered by continuing care contracts. A facility is not treated as a qualified continuing care facility unless substantially all facilities that are used to provide services required to be provided under a continuing care contract are owned or operated by the borrower. For these purposes, a nursing home is not a qualified continuing care facility.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment provision modifies the present-law exception under section 7872(g) relating to loans to continuing care facilities by eliminating the dollar cap on aggregate outstanding loans and making other modifications.

The Senate amendment provision provides an exception to the imputation rule of section 7872 for any calendar year for any below-market loan owed by a facility which on the last day of the year is a qualified continuing care facility, if the loan was made pursuant to a continuing care contract and if the lender or the lender's spouse attains age 62 before the close of the year.

For this purpose, a continuing care contract means a written contract between an individual and a qualified continuing care facility under which: (1) the individual or the individual's spouse may use a qualified continuing care facility for their life or lives; (2) the individual or the individual's spouse will be provided with housing in an independent living unit (which has additional available facilities outside such unit for the provision of meals and other personal care), an assisted living facility or nursing facility, as is available in the continuing care facility, as appropriate for the health of the individual or the individual's spouse; 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.

For this purpose, a qualified continuing care facility means one or more facilities: (1) that are designed to provide services under continuing care contracts; (2) that include an independent living unit, plus an assisted living or nursing facility, or both; and (3) substantially all of the independent living unit residents of which are covered by continuing care contracts. For these purposes, a nursing home is not a qualified continuing care facility.

Effective date.—The provision is effective for loans made after December 31, 2005.

CONFERENCE AGREEMENT

The conference agreement includes the Senate amendment provision, with modifications. The conference agreement provision provides that 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 their life or lives; (2) the individual or the individual's spouse will be provided with housing, as appropriate for the health of such individual or individual's spouse, (i)

in an independent living unit (which has additional available facilities outside such unit for the provision of meals and other personal care), and (ii) in an assisted living facility or a nursing facility, as is available in the continuing care facility; and (3) the individual or the individual's spouse will be provided assisted living or nursing care as the health of the individual or the individual's spouse requires, and as is available in the continuing care facility. The Secretary is required to issue guidance that limits the term "continuing care contract" to contracts that provide only facilities, care, and services described in the preceding sentence.

For purposes of defining the terms "continuing care contract" and "qualified continuing care facility" under the conference agreement provision, the term "assisted living facility" is intended to mean a facility at which assistance is provided (1) with activities of daily living (such as eating, toileting, transferring, bathing, dressing, and continence) or (2) 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.

Effective date.—The conference agreement provision is generally effective for calendar years beginning after December 31, 2005, with respect to loans made before, on, or after such date. The conference agreement provision does not apply to any calendar year after 2010. Thus, the conference agreement provision does not apply with respect to interest imputed after December 31, 2010. After such date, the law as in effect prior to enactment applies.

J. Exclusion of Gain on Sale of a Principal Residence by a Member of the Intelligence Community

(Sec. 311 of the Senate amendment 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 five 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.

HOUSE BILL

No provision.

SENATE AMENDMENT

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 at least one of such duty stations must be located outside of the Washington, D.C. and Baltimore metropolitan statistical areas, as defined by the Secretary of Commerce. 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.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

K. Sense of the Senate Regarding the Permanent Extension of EGTRRA and JGTRRA Provisions Relating to the Child Tax Credit

(Sec. 312 of the Senate amendment)

PRESENT LAW

Present law provides for the sunset of the child tax credit provisions under Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") and Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA").

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment includes a provision stating that it is the sense of the Senate that the conferees for the Tax Relief Act of 2006 should strive to permanently extend the amendments to the child tax credit made by EGTRRA and JGTRRA.

Effective date.—The Senate amendment provision is effective on the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

L. Partial Expensing for Advanced Mine Safety Equipment

(Sec. 313 of the Senate amendment)

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.[345]

[345] 1987–2 C.B. 674 (as clarified and modified by Rev. Proc. 88–22, 1988–1 C.B. 785).

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs. Present law provides that the maximum amount a taxpayer may expense, for taxable years beginning in 2003 through 2007, is $100,000 of the cost of qualifying property placed in service for the taxable year. 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.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment provides that the taxpayer may elect to treat 50 percent of the cost of any qualified advanced mine safety equipment property as a deduction in the taxable year in which the equipment is placed in service.

Advanced mine safety equipment property means any of the following: (1) emergency communication technology or devices used to allow a miner to maintain constant communication with an individual who is not in the mine; (2) electronic identification and location devices that allow individuals not in the mine to track at all times the movements and location of miners working in or at the mine; (3) emergency oxygen-generating, self-rescue devices that provide oxygen for at least 90 minutes; (4) pre-positioned supplies of oxygen providing each miner on a shift the ability to survive for at least 48 hours; and (5) comprehensive atmospheric monitoring systems that monitor the levels of carbon monoxide, methane and oxygen that are present in all areas of the mine and that can detect smoke in the case of a fire in a mine.

To be treated as qualified advanced mine safety equipment property under the provision, the original use of the property must have commenced with the taxpayer, and the taxpayer must have placed the property in service after the date of enactment.

The portion of the cost of any property with respect to which an expensing election under section 179 is made may not be taken into account for purposes of the 50-percent deduction allowed under this provision. For Federal tax purposes, the basis of property is reduced by the portion of its cost that is taken into account for purposes of the 50-percent deduction allowed under the provision.

The provision requires the taxpayer to report information required by the Treasury Secretary with respect to the operation of mines of the taxpayer, in order for the deduction to be allowed for the taxable year.

The provision includes a termination rule providing that it does not apply to property placed in service after the date that is three years after the date of enactment.

Effective date.—The provision applies to costs paid or incurred after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

M. MINE RESCUE TEAM TRAINING CREDIT

(Sec. 314 of the Senate amendment 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.[346] 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.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment provides that a taxpayer which is an eligible employer may claim a credit 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 each qualified mine rescue team employee (including wages of the employee), or (2) $10,000.[347] An eligible employer is any taxpayer which employs individuals as miners in underground mines in the United States. No deduction is allowed for the amount of the expenses otherwise deductible which is equal to the amount of the credit.

A qualified mine rescue team employee is any full-time employee of the taxpayer who is a miner eligible for more than six months of a taxable year to serve as a mine rescue team member by virtue of either having completed the initial 20-hour course of instruction prescribed by the Mine Safety and Health Administration's Office of Educational Policy and Development, or receiving at least 40 hours of refresher training in such instruction.

Effective date.—The provision is effective for taxable years beginning after December 31, 2005, and before January 1, 2009.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

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[346] Sec. 162(a).

[347] The credit is part of the general business credit (sec. 38).

N. Funding for Veterans Health Care and Disability Compensation and Hospital Infrastructure for Veterans

(Sec. 315 of the Senate amendment)

PRESENT LAW

Within the U.S. Department of Veterans Affairs, the Veterans Health Administration provides a broad spectrum of medical, surgical, and rehabilitative care to veterans. The Veteran Benefits Administration provides services to veterans, including services related to compensation and pensions.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment authorizes the appropriation of funds for the Department of Veterans Affairs for the Veterans Health Administration for Medical Care as well as the Veterans Benefits Administration for Compensation and Pensions for fiscal years 2006 through 2010 in the amounts listed below. The amounts authorized are in addition to any other amounts authorized for these Administrations under any other provision of law.

Fiscal year	Veterans health administration	Veterans benefits administration
2006	$900,000,000	$2,300,000,000
2007	1,300,000,000	2,700,000,000
2008	1,500,000,000	3,000,000,000
2009	1,600,000,000	3,000,000,000
2010	1,600,000,000	3,000,000,000

The Senate amendment also establishes the Veterans Hospital Improvement Fund, with an initial balance of $1,000,000,000, to be administered by the Secretary of Veterans Affairs. The funds are to be used for improvements of health facilities treating veterans.

Effective date.—The Senate amendment is effective upon the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

O. Sense of the Senate Regarding Protecting Middle-Class Families From the Alternative Minimum Tax

(Sec. 316 of the Senate amendment)

PRESENT LAW

Present law imposes an alternative minimum tax. The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the

remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds an exemption amount. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments.

Under present law, for taxable years beginning before January 1, 2009, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent, and dividends received by an individual from domestic corporations and qualified foreign corporations are taxed at the same rates that apply to capital gains. For taxable years beginning after December 31, 2008, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent, and dividends received by an individual are taxed as ordinary income at rates of up to 35 percent.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment provides that it is the sense of the Senate that protecting middle-class families from the alternative minimum tax should be a higher priority for Congress in 2006 than extending a tax cut that does not expire until the end of 2008.

Effective date.—The provision is effective on the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

TITLE V—REVENUE OFFSET PROVISIONS

A. Provisions Designed to Curtail Tax Shelters

1. Understatement of taxpayer's liability by income tax return preparer (Sec. 401 of the Senate amendment and sec. 6694 of the Code)

PRESENT LAW

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

HOUSE BILL

No provision.

SENATE AMENDMENT

The provision alters the standards of conduct that must be met to avoid imposition of the first penalty described above by replacing

the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The provision also replaces the not-frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position, increases the present-law $250 penalty to $1,000, and increases the present-law $1,000 penalty to $5,000.

Effective date.—The provision is effective for documents prepared after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

2. Frivolous tax submissions (Sec. 402 of the Senate amendment 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[348] to impose a penalty of up to $25,000 if a taxpayer has instituted or maintained proceedings primarily for delay or if the taxpayer's position in the proceeding is frivolous or groundless (sec. 6673(a)).

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment 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 Senate amendment 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 Senate amendment applies are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the Senate amendment permits the IRS to disregard such requests. Second, the Senate amendment 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 Senate amendment 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 Senate amendment applies to submissions made and issues raised after the date on which the Secretary first prescribes the required list of frivolous positions.

[348] 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.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

3. Penalty for promoting abusive tax shelters (sec. 403 of the Senate amendment and sec. 6700 of the Code)

PRESENT LAW

A penalty is imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement.[349] A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

In the case of a gross valuation overstatement, the amount of the penalty is $1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith. In the case of any activity that involves a qualified false or fraudulent statement, the penalty amount is equal to 50 percent of the gross income derived by the person from the activity.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment modifies the penalty rate imposed on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement. The penalty is equal to 100 percent of the gross income derived (or to be derived) from the activity. The penalty amount is calculated with respect to each instance of an activity subject to the penalty, each instance in which income was derived by the person or persons subject to the penalty, and each person who participated in an activity subject to the penalty.

[349] Sec. 6700.

Under the Senate amendment, if more than one person is liable for the penalty, all such persons are jointly and severally liable for the penalty. In addition, the Senate amendment provides that the penalty, as well as amounts paid to settle or avoid the imposition of the penalty, is not deductible for tax purposes.

Effective date.—The provision is effective for activities occurring after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

4. Penalty for aiding and abetting the understatement of tax liability (sec. 404 of the Senate amendment and sec. 6701 of the Code)

PRESENT LAW

A penalty is imposed on a person who: (1) aids or assists in, procures, or advises with respect to a tax return or other document; (2) knows (or has reason to believe) that such document will be used in connection with a material tax matter; and (3) knows that this would result in an understatement of tax of another person. In general, the amount of the penalty is $1,000. If the document relates to the tax return of a corporation, the amount of the penalty is $10,000.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment expands the scope of the penalty in several ways. First, it applies the penalty to aiding or assisting with respect to tax liability reflected in a tax return. Second, it applies the penalty to each instance of aiding or abetting. Third, it increases the amount of the penalty to a maximum of 100 percent of the gross income derived (or to be derived) from the aiding or abetting. Fourth, if more than one person is liable for the penalty, all such persons are jointly and severally liable for the penalty. Fifth, the penalty, as well as amounts paid to settle or avoid the imposition of the penalty, is not deductible for tax purposes.

Effective date.—The provision is effective for activities occurring after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

B. Economic Substance Doctrine

1. Clarification of the economic substance doctrine (sec. 411 of the Senate amendment)

PRESENT LAW

In general

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

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of tax motivated transactions, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. Although these doctrines serve an important role in the administration of the tax system, invocation of these doctrines can be seen as at odds with an objective, "rule-based" system of taxation. Nonetheless, courts have applied the doctrines to deny tax benefits arising from certain transactions.[350]

A common-law doctrine applied with increasing frequency is the "economic substance" doctrine. In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax.[351]

Economic substance doctrine

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

> The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[352]

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[350] See, e.g., *ACM Partnership* v. *Commissioner,* 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999).

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

[352] *ACM Partnership* v. *Commissioner,* 73 T.C.M. at 2215.

Business purpose doctrine

Another common law doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine. The business purpose test is a subjective inquiry into the motives of the taxpayer—that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[353]

Application by the courts

Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine.[354] Some courts apply a conjunctive test that requires a taxpayer to establish the presence of both economic substance (i.e., the objective component) and business purpose (i.e., the subjective component) in order for the transaction to survive judicial scrutiny.[355] A narrower approach used by some courts is to conclude that either a business purpose or economic substance is sufficient to respect the transaction).[356] A third approach regards economic substance and business purpose as "simply more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits.[357]

Recently, the Court of Federal Claims questioned the continuing viability of the doctrine.[358] The court also stated that "the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers."[359]

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[353] *ACM Partnership* v. *Commissioner,* 157 F.3d at 256 n.48.

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

[355] See, e.g., *Pasternak* v. *Commissioner,* 990 F.2d 893, 898 (6th Cir. 1993) ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.").

[356] See, e.g., *Rice's Toyota World* v. *Commissioner,* 752 F.2d 89, 91–92 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists."); *IES Industries* v. *United States,* 253 F.3d 350, 358 (8th Cir. 2001) ("In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose out of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists (the economic substance test)."). As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied interchangeably. For a more detailed discussion of the sham transaction doctrine, see, e.g., Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS–3–99) at 182.

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

[358] *Coltec Industries, Inc.* v. *United States,* 62 Fed. Cl. 716 (2004) (slip opinion at 123–124). The court also found, however, that the doctrine was satisfied in that case. *Id.* at 128.

[359] *Id.* at 128.

Nontax economic benefits

There also is a lack of uniformity regarding the type of non-tax economic benefit a taxpayer must establish in order to satisfy economic substance. Several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.[360] In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.[361] Under this analysis, the taxpayer's profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the tax benefits.[362] In these cases, in assessing whether a reasonable possibility of profit exists, it is sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits.

Financial accounting benefits

In determining whether a taxpayer had a valid business purpose for entering into a transaction, at least one court has concluded that financial accounting benefits arising from tax savings do not qualify as a non-tax business purpose.[363] However, based on court decisions that recognize the importance of financial accounting treatment, taxpayers have asserted that financial accounting benefits arising from tax savings can satisfy the business purpose test.[364]

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment provision clarifies and enhances the application of the economic substance doctrine. Under the provision, in a case in which a court determines that the economic substance doctrine is relevant to a transaction (or a series of transactions), such transaction (or series of transactions) has economic

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[360] See, e.g., *Knetsch,* 364 U.S. at 361; *Goldstein* v. *Commissioner,* 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance).

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

[362] See, e.g., *Rice's Toyota World* v. *Commissioner,* 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp.* v. *Commissioner,* 277 F.3d at 781 (applied the same test, citing *Rice's Toyota World*); *IES Industries* v. *United States,* 253 F.3d 350, 354 (8th Cir. 2001). s

[363] See, *American Electric Power, Inc.* v. *U.S.,* 136 F. Supp. 2d 762, 791–92 (S.D. Ohio 2001); *aff'd* 326 F.3d.737 (6th Cir. 2003).

[364] See, e.g., Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JSC–3–03) February, 2003 ("Enron Report"), Volume III at C–93, 289. Enron Corporation relied on *Frank Lyon Co.* v. *United States,* 435 U.S. 561, 577–78 (1978), and *Newman* v. *Commissioner*, 902 F.2d 159, 163 (2d Cir. 1990) to argue that financial accounting benefits arising from tax savings constitutes a good business purpose.

substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.[365]

The provision does not change current law standards used by courts in determining when to utilize an economic substance analysis.[366] Also, the provision does not alter the court's ability to aggregate, disaggregate or otherwise recharacterize a transaction when applying the doctrine.[367] The provision provides a uniform definition of economic substance, but does not alter the flexibility of the courts in other respects.

Conjunctive analysis

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

Non-tax business purpose

Under the provision, a taxpayer's non-tax purpose for entering into a transaction (the second prong in the analysis) must be "substantial," and the transaction must be "a reasonable means" of accomplishing such purpose. Under this formulation, the non-tax purpose for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities.[368]

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

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

[367] See, e.g., *Minnesota Tea Co.* v. *Helvering,* 302 U.S. 609, 613 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path.").

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

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In determining whether a taxpayer has a substantial non-tax business purpose, an objective of achieving a favorable accounting treatment for financial reporting purposes will not be treated as having a substantial non-tax purpose.[369] Furthermore, a transaction that is expected to increase financial accounting income as a result of generating tax deductions or losses without a corresponding financial accounting charge (i.e., a permanent book-tax difference)[370] should not be considered to have a substantial non-tax purpose unless a substantial non-tax purpose exists apart from the financial accounting benefits.[371]

By requiring that a transaction be a "reasonable means" of accomplishing its non-tax purpose, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[372]

Profit potential

Under the provision, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position; the provision merely sets forth a minimum threshold of profit potential if that test is relied on to demonstrate a meaningful change in economic position. If a taxpayer relies on a profit potential, however, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.[373] Moreover, the profit potential must exceed a risk-free rate of re-

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

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

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

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

[371] Claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement. See, e.g., *American Electric Power, Inc.* v. *U.S.,* 136 F. Supp. 2d 762, 791–92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'") (citing *Winn-Dixie* v. *Commissioner,* 113 T.C. 254, 287 (1999)); aff'd 326 F3d 737 (6th Cir. 2003).

[372] See, e.g., *ACM Partnership* v. *Commissioner,* 157 F.3d at 256 n.48.

[373] Thus, a "reasonable possibility of profit" will not be sufficient to establish that a transaction has economic substance.

turn. In addition, in determining pre-tax profit, fees and other transaction expenses and foreign taxes are treated as expenses.

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

Transactions with tax-indifferent parties

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

Other rules

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

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

Effective date.—The provision applies to transactions entered into after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

2. Penalty for understatements attributable to transactions lacking economic substance, etc. (sec. 412 of the Senate amendment)

PRESENT LAW

General accuracy-related penalty

An accuracy-related penalty under section 6662 applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that re-

ported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 (or, in the case of corporations, by the lesser of (a) 10 percent of the correct tax (or $10,000 if greater) or (b) $10 million), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[374] Except in the case of tax shelters,[375] the amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. The Treasury Secretary may prescribe a list of positions which the Secretary believes do not meet the requirements for substantial authority under this provision.

The section 6662 penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[376] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[377]

Listed transactions and reportable avoidance transactions

In general

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

Both listed transactions and reportable transactions are allowed to be described by the Treasury Department under section 6707A(c), which imposes a penalty for failure adequately to report such transactions under section 6011. A reportable transaction is defined as one that the Treasury Secretary determines is required to be disclosed because it is determined to have a potential for tax avoidance or evasion.[378] A listed transaction is defined as a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of the reporting disclosure requirements.[379]

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[374] Sec. 6662.

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

[376] Sec. 6664(c).

[377] Treas. Reg. sec. 1.6662–4(g)(4)(i)(B); Treas. Reg. sec. 1.6664–4(c).

[378] Sec. 6707A(c)(1).

[379] Sec. 6707A(c)(2).

Disclosed transactions

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction.[380] The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the "strengthened reasonable cause exception"), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

Undisclosed transactions

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a strict-liability penalty generally applies), and the taxpayer is subject to an increased penalty equal to 30 percent of the understatement.[381] However, a taxpayer will be treated as having adequately disclosed a transaction for this purpose if the IRS Commissioner has separately rescinded the separate penalty under section 6707A for failure to disclose a reportable transaction.[382] The IRS Commissioner is authorized to do this only if the failure does not relate to a listed transaction and only if rescinding the penalty would promote compliance and effective tax administration.[383]

A public entity that is required to pay a penalty for an undisclosed listed or reportable transaction must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear; and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).[384]

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of this provision, the amount of the understatement is determined as the sum of: (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return);[385] and (2) the amount of any decrease in

[380] Sec. 6662A(a).
[381] Sec. 6662A(c).
[382] Sec. 6664(d).
[383] Sec. 6707A(d).
[384] Sec. 6707A(e).
[385] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would

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

Except as provided in regulations, a taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.[386]

Strengthened reasonable cause exception

A penalty is not imposed under the provision with respect to any portion of an understatement if it is shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires: (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011;[387] (2) that there is or was substantial authority for such treatment; and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief: (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed; and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.[388]

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

Disqualified tax advisor

A disqualified tax advisor is any advisor who: (1) is a material advisor[389] and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267(b) or 707(b)(1)) to any person who so participates; (2) is compensated directly or indirectly[390] by a material advisor with respect to the transaction; (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained; or (4) as

(without regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income. Sec. 6662A(b).

[386] Sec. 6662A(e)(3).

[387] See the previous discussion regarding the penalty for failing to disclose a reportable transaction.

[388] Sec. 6664(d).

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

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

determined under regulations prescribed by the Secretary, has a disqualifying financial interest with respect to the transaction.

A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents: (1) establishing a structure used in connection with the transaction (such as a partnership agreement); (2) describing the transaction (such as an offering memorandum or other statement describing the transaction); or (3) relating to the registration of the transaction with any federal, state or local government body.[391] Participation in the "management" of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

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

Coordination with other penalties

To the extent a penalty on an understatement is imposed under section 6662A, that same amount of understatement is not also subject to the accuracy-related penalty under section 6662(a) or to the valuation misstatement penalties under section 6662(e) or 6662(h). However, such amount of understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1) and for purposes of identifying an underpayment under the section 6663 fraud penalty.

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

HOUSE BILL

No provision.

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

SENATE AMENDMENT

The Senate amendment provision imposes a new, stronger penalty for an understatement attributable to any transaction that lacks economic substance (referred to in the statute as a "non-economic substance transaction understatement").[392] The penalty rate is 40 percent (reduced to 20 percent if the taxpayer adequately discloses the relevant facts in accordance with regulations prescribed under section 6011). No exceptions (including the reasonable cause or rescission rules) to the penalty are available (i.e., the penalty is a strict-liability penalty).

A "non-economic substance transaction" means any transaction if (1) the transaction lacks economic substance (as defined in the Senate amendment provision regarding the clarification of the economic substance doctrine),[393] (2) the transaction was not respected under the rules relating to transactions with tax-indifferent parties (as described in the Senate amendment provision regarding the clarification of the economic substance doctrine),[394] or (3) any similar rule of law. For this purpose, a similar rule of law would include, for example, an understatement attributable to a transaction that is determined to be a sham transaction.

For purposes of the bill, the calculation of an "understatement" is made in the same manner as in the present law provision relating to accuracy-related penalties for listed and reportable avoidance transactions (sec. 6662A). Thus, the amount of the understatement under the provision would be determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return),[395] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. In essence, the penalty will apply to the amount of any understatement attributable solely to a non-economic substance transaction.

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

[392] Thus, unlike the present-law accuracy-related penalty under section 6662A (which applies only to listed and reportable avoidance transactions), the new penalty under the provision applies to any transaction that lacks economic substance.

[393] That Senate amendment provision generally provides that in any case in which a court determines that the economic substance doctrine is relevant, a transaction has economic substance only if: (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose. Specific other rules also apply. See "Explanation of Provision" for the immediately preceding Senate amendment provision, "Clarification of the economic substance doctrine."

[394] That Senate amendment provision provides that the form of a transaction that involves a tax-indifferent party will not be respected in certain circumstances. See "Explanation of Provision" for the immediately preceding Senate amendment provision, "Clarification of the economic substance doctrine."

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

the date the taxpayer is first contacted regarding an examination of such return or such other date as specified by the Secretary.

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

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

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

Effective date.—The provision applies to transactions entered into after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not contain the Senate amendment provision.

3. Denial of deduction for interest on underpayments attributable to noneconomic substance transactions (sec. 413 of the Senate amendment and sec. 163(m) of the Code)

PRESENT LAW

No deduction for interest is allowed for interest paid or accrued on any underpayment of tax which is attributable to the portion of any reportable transaction understatement with respect to which the relevant facts were not adequately disclosed.[396] The Secretary

[396] Sec. 163(m). Under section 6664(d)(2)(A), in such a case of nondisclosure, the taxpayer also is not entitled to the "reasonable cause and good faith" exception to the section 6662A penalty for a reportable transaction understatement.

of the Treasury is authorized to define reportable transactions for this purpose.[397]

HOUSE BILL

No provision.

SENATE AMENDMENT

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

Effective date.—The provision applies to transactions after the date of enactment in taxable years ending after such date.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

C. Improvements in Efficiency and Safeguards in Internal Revenue Service Collections

1. Waiver of user fee for installment agreements using automated withdrawals (sec. 421 of the Senate amendment and sec. 6159 of the Code)

PRESENT LAW

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed.[398] An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

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

HOUSE BILL

No provision.

SENATE AMENDMENT

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

Effective date.—The provision is effective with respect to agreements entered into on or after the date which is 180 days after the date of enactment.

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[397] See the description of present law with respect to the immediately preceding Senate amendment provision, "Penalty for understatements attributable to transactions lacking economic substance, etc."

[398] Sec. 6159.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

2. Termination of installment agreements (sec. 422 of the Senate amendment and sec. 6159 of the Code)

PRESENT LAW

The Code authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments, if the IRS determines that doing so will facilitate collection of the amounts owed.[399] An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

Under present law, the IRS is permitted to terminate an installment agreement only if: (1) the taxpayer fails to pay an installment at the time the payment is due; (2) the taxpayer fails to pay any other tax liability at the time when such liability is due; (3) the taxpayer fails to provide a financial condition update as required by the IRS; (4) the taxpayer provides inadequate or incomplete information when applying for an installment agreement; (5) there has been a significant change in the financial condition of the taxpayer; or (6) the collection of the tax is in jeopardy.[400]

HOUSE BILL

No provision.

SENATE AMENDMENT

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

Effective date.—The provision is effective for failures occurring on or after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

[399] Sec. 6159.
[400] Sec. 6159(b)(2), (3), and (4).

3. Partial payments required with submissions of offers-in-compromise (sec. 423 of the Senate amendment and sec. 7122 of the Code)

PRESENT LAW

The IRS has the authority to compromise any civil or criminal case arising under the internal revenue laws.[401] In general, taxpayers initiate this process by making an offer-in-compromise, which is an offer by the taxpayer to settle an outstanding tax liability for less than the total amount due. The IRS currently imposes a user fee of $150 on most offers, payable upon submission of the offer to the IRS. Taxpayers may justify their offers on the basis of doubt as to collectibility or liability or on the basis of effective tax administration. In general, enforcement action is suspended during the period that the IRS evaluates an offer. In some instances, it may take the IRS 12 to 18 months to evaluate an offer.[402] Taxpayers are permitted (but not required) to make a deposit with their offer; if the offer is rejected, the deposit is generally returned to the taxpayer. There are two general categories[403] of offers-in-compromise, lump-sum offers and periodic payment offers. Taxpayers making lump-sum offers propose to make one lump-sum payment of a specified dollar amount in settlement of their outstanding liability. Taxpayers making periodic payment offers propose to make a series of payments over time (either short-term or long-term) in settlement of their outstanding liability.

HOUSE BILL

No provision.

SENATE AMENDMENT

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

The provision also provides that an offer is deemed accepted if the IRS does not make a decision with respect to the offer within two years from the date the offer was submitted.

The Senate amendment authorizes the Secretary to issue regulations providing exceptions to the partial payment requirements in

[401] Sec. 7122.

[402] *Olsen* v. *United States*, 326 F. Supp. 2d 184 (D. Mass. 2004).

[403] The IRS categorizes payment plans with more specificity, which is generally not significant for purposes of the provision. See Form 656, Offer in Compromise, page 6 of instruction booklet (revised July 2004).

the case of offers from certain low-income taxpayers and offers based on doubt as to liability.

Effective date.—The provision is effective for offers-in-compromise submitted on and after the date which is 60 days after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement includes the Senate amendment provision, with the following modifications. Under the conference agreement, any user fee imposed by the IRS for participation in the offer-in-compromise program must be submitted with the appropriate partial payment. The user fee is applied to the taxpayer's outstanding tax liability. In addition, under the conference agreement, offers submitted to the IRS that do not comport with the payment requirements may be returned to the taxpayer as unprocessable.

D. Penalties and Fines

1. Increase in criminal monetary penalty limitation for the underpayment or overpayment of tax due to fraud (sec. 431 of the Senate amendment and secs. 7201, 7203, and 7206 of the Code)

PRESENT LAW

Attempt to evade or defeat tax

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

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

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

Fraud and false statements

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

Uniform sentencing guidelines

Under the uniform sentencing guidelines established by 18 U.S.C. 3571, a defendant found guilty of a criminal offense is subject to a maximum fine that is the greatest of: (a) the amount spec-

ified in the underlying provision, (b) for a felony[404] $250,000 for an individual or $500,000 for an organization, or (c) twice the gross gain if a person derives pecuniary gain from the offense. This Title 18 provision applies to all criminal provisions in the United States Code, including those in the Internal Revenue Code. For example, for an individual, the maximum fine under present law upon conviction of violating section 7206 is $250,000 or, if greater, twice the amount of gross gain from the offense.

HOUSE BILL

No provision.

SENATE AMENDMENT

Attempt to evade or defeat tax

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

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

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

Fraud and false statements

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

Effective date

The provision is effective for actions and failures to act occurring after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

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

2. Doubling of certain penalties, fines, and interest on underpayments related to certain offshore financial arrangements (sec. 432 of the Senate amendment)

PRESENT LAW

In general

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

Delinquency penalties

Failure to file.—Under present law, a taxpayer who fails to file a tax return on a timely basis is generally subject to a penalty equal to 5 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent. An exception from the penalty applies if the failure is due to reasonable cause. In the case of fraudulent failure to file, the penalty is increased to 15 percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 75 percent. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.

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

Failure to make timely deposits of tax.—The penalty for the failure to make timely deposits of tax consists of a four-tiered structure in which the amount of the penalty varies with the length of time within which the taxpayer corrects the failure. A depositor is subject to a penalty equal to 2 percent of the amount of the underpayment if the failure is corrected on or before the date that is five days after the prescribed due date. A depositor is subject to a penalty equal to 5 percent of the amount of the underpayment if the failure is corrected after the date that is five days after the prescribed due date but on or before the date that is 15

days after the prescribed due date. A depositor is subject to a penalty equal to 10 percent of the amount of the underpayment if the failure is corrected after the date that is 15 days after the due date but on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). Finally, a depositor is subject to a penalty equal to 15 percent of the amount of the underpayment if the failure is not corrected on or before earlier of 10 days after the date of the first delinquency notice to the taxpayer and 10 days after the date on which notice and demand for immediate payment of tax is given in cases of jeopardy.

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

Accuracy-related penalties

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

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

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

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

Substantial valuation misstatement.—A penalty applies to the portion of an underpayment that is attributable to a substantial valuation misstatement. Generally, a substantial valuation

misstatement exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the correct value or adjusted basis. The amount of the penalty for a substantial valuation misstatement is 20 percent of the amount of the underpayment if the value or adjusted basis claimed is 200 percent or more but less than 400 percent of the correct value or adjusted basis. If the value or adjusted basis claimed is 400 percent or more of the correct value or adjusted basis, then the overvaluation is a gross valuation misstatement.

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

Fraud penalty

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

Assessable penalties

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

Interest provisions

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

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

Offshore Voluntary Compliance Initiative

In January 2003, Treasury announced the Offshore Voluntary Compliance Initiative ("OVCI") to encourage the voluntary disclosure of previously unreported income placed by taxpayers in offshore accounts and accessed through credit card or other financial arrangements. A taxpayer had to comply with various requirements in order to participate in the OVCI, including sending a written request to participate in the program by April 15, 2003. This request had to include information about the taxpayer, the taxpayer's introduction to the credit card or other financial arrangements and the names of parties that promoted the transaction. A taxpayer entering into a closing agreement under the OVCI is not liable for the civil fraud penalty, the fraudulent failure to file penalty, or the civil information return penalties. Such a tax-

payer is responsible for back taxes, interest, and certain accuracy-related and delinquency penalties.[405]

Voluntary disclosure policy

A taxpayer's timely, voluntary disclosure of a substantial unreported tax liability has long been an important factor in deciding whether the taxpayer's case should ultimately be referred for criminal prosecution. The voluntary disclosure must be truthful, timely, and complete. The taxpayer must show a willingness to cooperate (as well as actual cooperation) with the IRS in determining the correct tax liability. The taxpayer must make good-faith arrangements with the IRS to pay in full the tax, interest, and any penalties determined by the IRS to be applicable. A voluntary disclosure does not guarantee immunity from prosecution. It creates no substantive or procedural rights for taxpayers.[406] The IRS treats participation in the OVCI as a voluntary disclosure.[407]

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment doubles the amounts of civil penalties, interest, and fines related to taxpayers' underpayments of U.S. income tax liability through the direct or indirect use of certain offshore financial arrangements. The provision applies to taxpayers who did not (or do not) voluntarily disclose such arrangements through the OVCI or otherwise. Under the Senate amendment, the determination of whether any civil penalty is to be applied to such underpayment is made without regard to whether a return has been filed, whether there was reasonable cause for such underpayment, and whether the taxpayer acted in good faith.

The proscribed financial arrangements include, but are not limited to, the use of certain foreign leasing corporations for providing domestic employee services,[408] certain arrangements whereby the taxpayer may hold securities trading accounts through offshore banks or other financial intermediaries, certain arrangements whereby the taxpayer may access funds through the use of offshore credit, debit, or charge cards, and offshore annuities or trusts.

The Secretary of the Treasury is granted the authority to waive the application of the provision if the use of the offshore financial arrangements is incidental to the transaction and, in the case of a trade or business, such use is conducted in the ordinary course of the type of trade or business in which the taxpayer is engaged.

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

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[405] Rev. Proc. 2003–11, 2003–4 C.B. 311.
[406] Internal Revenue News Release 2002–135, IR–2002–135 (December 11, 2002).
[407] Rev. Proc. 2003–11, 2003–4 C.B. 311.
[408] These arrangements were described and classified as listed transactions in Notice 2003–22, 2003–1 C.B. 851.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

3. Denial of deduction for certain fines, penalties, and other amounts (sec. 433 of the Senate Amendment and sec. 162 of the Code)

PRESENT LAW

Under present law, no deduction is allowed as a trade or business expense under section 162(a) for the payment of a fine or similar penalty to a government for the violation of any law (sec. 162(f)). The enactment of section 162(f) in 1969 codified existing case law that denied the deductibility of fines as ordinary and necessary business expenses on the grounds that "allowance of the deduction would frustrate sharply defined national or State policies proscribing the particular types of conduct evidenced by some governmental declaration thereof."[409]

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

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment provision modifies the rules regarding the determination whether payments are nondeductible payments of fines or penalties under section 162(f). In particular, the provision generally provides that amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government in relation to the violation of any law or the investigation or inquiry into the potential violation of any law[410] are nondeductible under any provision of the income tax provisions.[411] The provision

[409] S. Rep. No. 91–552, 91st Cong, 1st Sess., 273–74 (1969), referring to *Tank Truck Rentals, Inc.* v. *Commissioner,* 356 U.S. 30 (1958).

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

[411] The provision provides that such amounts are nondeductible under chapter 1 of the Internal Revenue Code.

applies to deny a deduction for any such payments, including those where there is no admission of guilt or liability and those made for the purpose of avoiding further investigation or litigation. An exception applies to payments that the taxpayer establishes are either restitution (including remediation of property), or amounts required to come into compliance with any law that was violated or involved in the investigation or inquiry, and that are identified in the court order or settlement as restitution, remediation, or required to come into compliance.[412] The IRS remains free to challenge the characterization of an amount so identified; however, no deduction is allowed unless the identification is made.[413]

An exception also applies to any amount paid or incurred as taxes due.[414]

The provision is intended to apply only where a government (or other entity treated in a manner similar to a government under the amendment) is a complainant or investigator with respect to the violation or potential violation of any law.[415]

It is intended that a payment will be treated as restitution (including remediation of property) only if substantially all of the payment is required to be paid to the specific persons, or in relation to the specific property, actually harmed by the conduct of the taxpayer that resulted in the payment. Thus, a payment to or with respect to a class substantially broader than the specific persons or property that were actually harmed (e.g., to a class including similarly situated persons or property) does not qualify as restitution or included remediation of property.[416] Restitution and included remediation of property is limited to the amount that bears a substantial quantitative relationship to the harm caused by the past conduct or actions of the taxpayer that resulted in the payment in question. If the party harmed is a government or other entity, then restitution and included remediation of property includes payment to such harmed government or entity, provided the payment bears a substantial quantitative relationship to the harm. However, restitution or included remediation of property does not include reimbursement of government investigative or litigation costs, or payments to whistleblowers.

It is intended that a payment will be treated as an amount required to come into compliance only if it directly corrects a viola-

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[412] The provision does not affect the treatment of antitrust payments made under section 4 of the Clayton Act, which continue to be governed by the provisions of section 162(g).

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

[414] Thus, amounts paid or incurred as taxes due are not affected by the provision (e.g., State taxes that are otherwise deductible). The reference to taxes due is also intended to include interest with respect to such taxes (but not interest, if any, with respect to any penalties imposed with respect to such taxes).

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

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

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

The provision requires government agencies to report to the IRS and to the taxpayer the amount of each settlement agreement or order entered where the aggregate amount required to be paid or incurred to or at the direction of the government under such settlement agreements and orders with respect to the violation, investigation, or inquiry is least $600 (or such other amount as may be specified by the Secretary of the Treasury as necessary to ensure the efficient administration of the Internal Revenue laws). The reports must be made within 30 days of the date the court order is issued or the settlement agreement is entered into, or such other time as may be required by Secretary. The report must separately identify any amounts that are restitution or remediation of property, or correction of noncompliance.[417]

The IRS is encouraged to require taxpayers to identify separately on their tax returns the amounts of any such settlements with respect to which reporting is required under the provision, including separate identification of the nondeductible amount and of any amount deductible as restitution, remediation, or required to correct noncompliance.[418]

Amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, any self-regulatory entity that regulates a financial market or other market that is a qualified board or exchange under section 1256(g)(7), and that is authorized to impose sanctions (e.g., the National Association of Securities Dealers) are likewise subject to the provision if paid in relation to a violation, or investigation or inquiry into a potential violation, of any law (or any rule or other requirement of such entity). To the extent provided in regulations, amounts paid or incurred to, or at the direction of, any other nongovernmental entity that exercises self-

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

[418] For example, the IRS might require such reporting as part of the schedule M–3, whether or not the particular amounts create a book-tax difference.

regulatory powers as part of performing an essential governmental function are similarly subject to the provision. The exception for payments that the taxpayer establishes are paid or incurred for restitution, remediation of property, or coming into compliance and that are identified as such in the order or settlement agreement likewise applies in these cases. The requirement of reporting to the IRS and the taxpayer also applies in these cases.

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

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

CONFERENCE AGREEMENT

The conference agreement does not contain the Senate amendment provision.

4. Denial of deduction for punitive damages (sec. 434 of the Senate amendment and sec. 162 of the Code)

PRESENT LAW

In general, a deduction is allowed for all ordinary and necessary expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business.[419] However, no deduction is allowed for any payment that is made to an official of any governmental agency if the payment constitutes an illegal bribe or kickback or if the payment is to an official or employee of a foreign government and is illegal under Federal law.[420] In addition, no deduction is allowed under present law for any fine or similar payment made to a government for violation of any law.[421] Furthermore, no deduction is permitted for two-thirds of any damage payments made by a taxpayer who is convicted of a violation of the Clayton antitrust law or any related antitrust law.[422]

In general, gross income does not include amounts received on account of personal physical injuries and physical sickness.[423] However, this exclusion does not apply to punitive damages.[424]

HOUSE BILL

No provision.

[419] Sec. 162(a).
[420] Sec. 162(c).
[421] Sec. 162(f).
[422] Sec. 162(g).
[423] Sec. 104(a).
[424] Sec. 104(a)(2).

SENATE AMENDMENT

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

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

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

5. Increase in penalty for bad checks and money orders (sec. 435 of the Senate amendment and sec. 6657 of the Code)

PRESENT LAW

The Code[425] imposes a penalty for bad checks and money orders on the person who tendered it. The penalty is two percent of the amount of the bad check or money order. For checks that are less than $750, the minimum penalty is $15 (or, if less, the amount of the check).

HOUSE BILL

No provision.

SENATE AMENDMENT

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

Effective date.—The provision is effective with respect to checks or money orders received after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

E. Provisions to Discourage Expatriation

1. Tax treatment of inverted corporate entities (sec. 441 of the Senate amendment and sec. 7874 of the Code)

PRESENT LAW

Determination of corporate residence

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

[425] Sec. 6657.

porated under the laws of foreign countries or U.S. possessions) generally are treated as foreign.

U.S. taxation of domestic corporations

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

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

U.S. taxation of foreign corporations

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

In addition, foreign corporations generally are subject to a gross-basis U.S. tax at a flat 30-percent rate on the receipt of interest, dividends, rents, royalties, and certain similar types of income derived from U.S. sources, subject to certain exceptions. The tax generally is collected by means of withholding by the person making the payment. This tax may be reduced or eliminated under an applicable tax treaty.

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

Prior to the American Jobs Creation Act of 2004 ("AJCA"), a U.S. corporation could reincorporate in a foreign jurisdiction and

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

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

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

In asset inversions, the U.S. corporation generally recognized gain (but not loss) under section 367(a) as though it had sold all

of its assets, but the shareholders generally did not recognize gain or loss, assuming the transaction met the requirements of a reorganization under section 368.

U.S. tax treatment of inversion transactions under AJCA

In general

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

Transactions involving at least 80 percent identity of stock ownership

The first type of inversion is a transaction in which, pursuant to a plan[426] or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. The provision denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.[427]

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

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of the provision are disregarded. In addition, the Treasury Secretary is to provide regulations to carry out the provision, including regulations to prevent the avoidance of the purposes of the provision, including avoidance through the use of related persons, pass-through or other noncor-

[426] Acquisitions with respect to a domestic corporation or partnership are deemed to be "pursuant to a plan" if they occur within the four-year period beginning on the date which is two years before the ownership threshold under the provision is met with respect to such corporation or partnership.

[427] Since the top-tier foreign corporation is treated for all purposes of the Code as domestic, the shareholder-level "toll charge" of sec. 367(a) does not apply to these inversion transactions.

porate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person or a member of an expanded affiliated group. Similarly, the Treasury Secretary has the authority to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the purposes of the provision.

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

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

Other rules

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

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

HOUSE BILL

No provision.

SENATE AMENDMENT

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

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

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

Effective date.—The provision in the Senate amendment is effective for taxable years ending after March 20, 2002.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

2. Revision of tax rules on expatriation of individuals (sec. 442 of the Senate amendment and secs. 102, 877, 2107, 2501, 7701, and 6039G of the Code)

PRESENT LAW

In general

U.S. citizens and residents generally are subject to U.S. income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. trade or business. The es-

tates of nonresident aliens generally are subject to estate tax on U.S.-situated property (e.g., real estate and tangible property located within the United States and stock in a U.S. corporation). Nonresident aliens generally are subject to gift tax on transfers by gift of U.S.-situated property (e.g., real estate and tangible property located within the United States), but excluding intangibles, such as stock, regardless of where they are located.

Income tax rules with respect to expatriates

For the 10 taxable years after an individual relinquishes his or her U.S. citizenship or terminates his or her U.S. long-term residency, unless certain conditions are met, the individual is subject to an alternative method of income taxation than that generally applicable to nonresident aliens (the "alternative tax regime"). Generally, the individual is subject to income tax for the 10-year period at the rates applicable to U.S. citizens, but only on U.S.-source income.[428]

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

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

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

Estate tax rules with respect to expatriates

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

[428] For this purpose, however, U.S.-source income has a broader scope than it does typically in the Code.

more than 50 percent of (a) the total combined voting power of all classes of stock entitled to vote in the foreign corporation, or (b) the total value of the stock of such corporation. If this stock ownership test is met, then the gross estate of the former citizen or former long-term resident includes that proportion of the fair market value of the foreign stock owned by the individual at the time of death, which the fair market value of any assets owned by such foreign corporation and situated in the United States (at the time of death) bears to the total fair market value of all assets owned by such foreign corporation (at the time of death).

Gift tax rules with respect to expatriates

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

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

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

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

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

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

residency termination, the individual is subject to U.S. gift tax on any transfer of his or her worldwide assets by gift during that taxable year.

For purposes of these rules, an individual is treated as present in the United States on any day if such individual is physically present in the United States at any time during that day. The present-law exceptions from being treated as present in the United States for residency purposes[429] generally do not apply for this purpose. However, for individuals with certain ties to countries other than the United States[430] and individuals with minimal prior physical presence in the United States,[431] a day of physical presence in the United States is disregarded if the individual is performing services in the United States on such day for an unrelated employer (within the meaning of sections 267 and 707(b)), who meets the requirements the Secretary of the Treasury may prescribe in regulations. No more than 30 days may be disregarded during any calendar year under this rule.

Annual return

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

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

HOUSE BILL

No provision.

SENATE AMENDMENT

In general

The Senate amendment creates new section 877A, that generally subjects certain U.S. citizens who relinquish their U.S. citi-

[429] Secs. 7701(b)(3)(D), 7701(b)(5) and 7701(b)(7)(B)–(D).

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

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

zenship and certain long-term U.S. residents who terminate their U.S. residence to tax on the net unrealized gain in their property as if such property were sold for fair market value on the day before the expatriation or residency termination ("mark-to-market tax"). Gain from the deemed sale is taken into account at that time without regard to other Code provisions. Any loss from the deemed sale generally is taken into account to the extent otherwise provided in the Code, except that the wash sale rules of section 1091 do not apply. Any net gain on the deemed sale, is recognized to the extent it exceeds $600,000 ($1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency). The $600,000 amount is increased by a cost of living adjustment factor for calendar years after 2005.

Individuals covered

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

Exceptions to an individual's classification as a covered expatriate are provided in two situations. The first exception applies to an individual who was born with citizenship both in the United States and in another country; provided that (1) as of the expatriation date the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual was not a resident of the United States for the five taxable years ending with the year of expatriation. The second exception applies to a U.S. citizen who relinquishes U.S. citizenship before reaching age 18½, provided that the individual was a resident of the United States for no more than five taxable years before such relinquishment.

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

In addition, the provision provides that, for all tax purposes (i.e., not limited to the mark-to-market tax), a U.S. citizen continues to be treated as a U.S. citizen for tax purposes until that

individual's citizenship is treated as relinquished under the rules of the immediately preceding paragraph. However, under Treasury regulations, relinquishment may occur earlier with respect to an individual who became at birth a citizen of the United Sates and of another country.

Election to be treated as a U.S. citizen

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

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

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

The deemed sale rule of the provision generally applies to all property interests held by the individual on the date of relinquishment of citizenship or termination of residency. Special rules apply in the case of trust interests, as described below. U.S. real property interests (which remain subject to U.S. tax in the hands of nonresident noncitizens), with the exception of stock of certain former U.S. real property holding corporations, are exempted from the provision. Regulatory authority is granted to the Treasury to exempt other types of property from the provision.

Under the provision, an individual who is subject to the mark-to-market tax is required to pay a tentative tax equal to the amount of tax that would be due for a hypothetical short tax year ending on the date the individual relinquishes citizenship or terminates residency. Thus, the tentative tax is based on all income,

gains, deductions, losses, and credits of the individual for the year through such date, including amounts realized from the deemed sale of property. Moreover, notwithstanding any other provision of the Code, any period during which recognition of income or gain had been deferred terminates on the day before relinquishment of citizenship or termination of residency (and, therefore, such income or gain recognition becomes part of the tax base of the tentative tax). The tentative tax is due on the 90th day after the date of relinquishment of citizenship or termination of residency, subject to the election, described below, to defer payments of the mark-to-market tax. In addition, notwithstanding any other provision of the Code, any extension of time for payment of tax ceases to apply on the day before relinquishment of citizenship or termination of residency, and the unpaid portion of such tax becomes due and payable at the time and in the manner prescribed by the Secretary of the Treasury.

Deferral of payment of mark-to-market tax

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

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

The deferred tax amount (including any interest, penalties, and certain other items) becomes a lien in favor of the United States on all U.S.-situated property owned by the individual. This lien arises on the expatriation date and continues until the tax liability is satisfied, the tax liability has become unenforceable by reason of lapse of time, or the Secretary is satisfied that no further tax liability may arise by reason of this provision. The rules of sec-

tion 6324A(d)(1), (3), and (4) (relating to liens arising in connection with the deferral of estate tax under section 6166) apply to such liens.

Retirement plans and similar arrangements

Subject to certain exceptions, the provision applies to all property interests held by covered expatriates at the time of relinquishment of citizenship or termination of residency. Accordingly, such property includes an interest in an employer-sponsored qualified plan or deferred compensation arrangement as well as an interest in an individual retirement account or annuity (i.e., an IRA).[432] However, the provision contains a special rule for an interest in a "retirement plan." For purposes of the provision, a "retirement plan" includes an employer-sponsored qualified plan (sec. 401(a)), a qualified annuity (sec. 403(a)), a tax-sheltered annuity (sec. 403(b)), an eligible deferred compensation plan of a governmental employer (sec. 457(b)), an individual retirement account (sec. 408(a)), and an individual retirement annuity (sec. 408(b)). The special retirement plan rule also applies, to the extent provided in regulations, to any foreign plan or similar retirement arrangement or program. An interest in a trust that is part of a retirement plan is subject to the special retirement plan rules and not to the rules for interests in trusts (discussed below).

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

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

[432] Application of the provision is not limited to an interest that meets the definition of property under section 83 (relating to property transferred in connection with the performance of services).

Interests in trusts

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

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

Nonqualified trusts.—If an individual holds an interest in a trust that is not a qualified trust, a special rule applies for purposes of determining the amount of the mark-to-market tax due with respect to such trust interest. The individual's interest in the trust is treated as a separate trust consisting of the trust assets allocable to such interest. Such separate trust is treated as having sold its net assets for their fair market value on the day before the date of relinquishment of citizenship or termination of residency and having distributed the assets to the individual, who then is treated as having recontributed the assets to the trust. Any income, gain, or loss of the individual arising from the deemed distribution from the trust is taken into account as if it had arisen under the deemed sale rules.

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

Qualified trusts.—If an individual has an interest in a qualified trust, the amount of mark-to-market tax on unrealized gain allocable to the individual's trust interest ("allocable expatriation gain") is calculated at the time of expatriation or residency termination, but is collected as the individual receives distributions from the qualified trust. The allocable expatriation gain is the amount of gain which would be allocable to the individual's trust interest if the individual directly held all the assets allocable to such interest.[433] If any individual's interest in a trust is vested as of the day before the expatriation date (e.g., if the individual's interest in the trust is non-contingent and non-discretionary), the gain allocable to the individual's trust interest is determined based on the trust assets allocable to his or her trust interest. If the individual's interest

[433] Allocable expatriation gain is subject to the $600,000 exemption (adjusted for cost of living increases).

in the trust is not vested as of the expatriation date (e.g., if the individual's trust interest is a contingent or discretionary interest), the gain allocable to his or her trust interest is determined based on all of the trust assets that could be allocable to his or her trust interest, determined by resolving all contingencies and discretionary powers in the individual's favor (i.e., the individual is allocated the maximum amount that he or she could receive).

Taxes are imposed on each distribution from a qualified trust. These distributions also may be subject to other U.S. income taxes. If a distribution from a qualified trust is made after the individual relinquishes citizenship or terminates residency, the mark-to-market tax is imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates for the taxable year which includes the date of expatriation, but in no event will the tax imposed exceed the balance in the "deferred tax account" with respect to the trust interest. For this purpose, the balance in the deferred tax account is equal to (1) the hypothetical tax calculated under the "regular" deemed sale rules with respect to the allocable expatriation gain, (2) increased by interest charged on the balance in the deferred tax account at a rate two percentage points higher than the rate normally applicable to individual underpayments, for periods beginning after the 90th day after the expatriation date and calculated up to 30 days prior to the date of the distribution, (3) reduced by any mark-to-market tax imposed on prior trust distributions to the individual, and (4) to the extent provided in Treasury regulations, in the case of a covered expatriate holding a nonvested interest, reduced by mark-to-market taxes imposed on trust distributions to other persons holding nonvested interests.

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

Mark-to-market taxes become due immediately if the trust ceases to be a qualified trust, the individual disposes of his or her qualified trust interest, or the individual dies. In such cases, the amount of mark-to-market tax equals the lesser of (1) the tax calculated under the rules for nonqualified trust interests as of the date of the triggering event, or (2) the balance in the deferred tax account with respect to the trust interest immediately before that date. Such tax is imposed on the trust, the trustee is personally liable for the tax, and any other beneficiary has a right of contribution against such individual (or his or her estate) with respect to such tax.

Regulatory authority

The provision authorizes the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 877A. In addition, the Secretary of the Treasury may provide for adjustments to the bases of assets in a

trust or a deferred tax account, and the timing of such adjustments, to ensure that gain is taxed only once.

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

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

Coordination with present-law alternative tax regime

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

Information reporting

Certain information reporting requirements under the law presently applicable to former citizens and former long-term residents (sec. 6039G) also apply for purposes of the provision.

Immigration rules

The provision denies former citizens reentry into the United States if the individual is determined not to be in compliance with his or her tax obligations under the provision's expatriation tax rules (regardless of the subjective motive for expatriating). For this purpose, the provision permits the IRS to disclose certain items of return information of an individual, upon written request of the Attorney General or his delegate, as is necessary for making a determination under section 212(a)(10)(E) of the Immigration and Nationality Act. Specifically, the provision permits the IRS to disclose to the agency administering section 212(a)(10)(E) whether such taxpayer is in compliance with section 877A, and to identify the items of any noncompliance. Recordkeeping requirements, safeguards,

and civil and criminal penalties for unauthorized disclosure or inspection apply to return information disclosed under this provision.

Effective date

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

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

F. MISCELLANEOUS PROVISIONS

1. Treatment of contingent payment convertible debt instruments (sec. 451 of the Senate amendment and sec. 1275 of the Code)

PRESENT LAW

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

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

Treasury regulations provide special rules for determining the amount of OID allocated to a period with respect to certain debt instruments that provide for one or more contingent payments of principal or interest.[434] The regulations provide that a debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt instrument into the stock of the issuer, into the stock or debt of a related party, or into cash or other property in an amount equal to the approximate value of such stock or debt.[435] The regulations also provide that a payment is not a contingent payment merely because of a contingency that, as of the issue date of the debt instrument, is either remote or incidental.[436]

In the case of contingent payment debt instruments that are issued for money or publicly traded property,[437] the regulations provide that interest on a debt instrument must be taken into account (as OID) whether or not the amount of any payment is fixed or determinable in the taxable year. The amount of OID that is taken into account for each accrual period is determined by constructing a comparable yield and a projected payment schedule for the debt instrument, and then accruing the OID on the basis of the comparable yield and projected payment schedule by applying rules similar to those for accruing OID on a noncontingent debt instrument (the "noncontingent bond method"). If the actual amount of a contingent payment is not equal to the projected amount, appropriate adjustments are made to reflect the difference. The comparable yield for a debt instrument is the yield at which the issuer would be able to issue a fixed-rate noncontingent debt instrument with terms and conditions similar to those of the contingent payment debt instrument (i.e., the comparable fixed-rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions.[438]

With respect to certain debt instruments that are convertible into the common stock of the issuer and that also provide for contingent payments (other than the conversion feature)—often referred to as "contingent convertible" debt instruments—the IRS has stated that the noncontingent bond method applies in computing the accrual of OID on the debt instrument.[439] In applying the noncontingent bond method, the IRS has stated that the comparable yield for a contingent convertible debt instrument is determined by reference to a comparable fixed-rate nonconvertible debt instrument, and the projected payment schedule is determined by treating the issuer stock received upon a conversion of the debt instrument as a contingent payment.

HOUSE BILL

No provision.

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[434] Treas. Reg. sec. 1.1275–4.
[435] Treas. Reg. sec. 1.1275–4(a)(4).
[436] Treas. Reg. sec. 1.1275–4(a)(5).
[437] Treas. Reg. sec. 1.1275–4(b).
[438] Treas. Reg. sec. 1.1275–4(b)(4)(i)(A).
[439] Rev. Rul. 2002–31, 2002–1 C.B. 1023.

SENATE AMENDMENT

The Senate amendment provides that, in the case of a contingent convertible debt instrument,[440] any Treasury regulations which require OID to be determined by reference to the comparable yield of a noncontingent fixed-rate debt instrument shall be applied as requiring that such comparable yield be determined by reference to a noncontingent fixed-rate debt instrument which is convertible into stock. For purposes of applying the provision, the comparable yield shall be determined without taking into account the yield resulting from the conversion of a debt instrument into stock. Thus, the noncontingent bond method in the Treasury regulations shall be applied in a manner such that the comparable yield for contingent convertible debt instruments shall be determined by reference to comparable noncontingent fixed-rate convertible (rather than nonconvertible) debt instruments.

Effective date.—The provision is effective for debt instruments issued on or after date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

2. Grant Treasury regulatory authority to address foreign tax credit transactions involving inappropriate separation of foreign taxes from related foreign income (sec. 452 of the Senate amendment and sec. 901 of the Code)

PRESENT LAW

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

For purposes of the foreign tax credit, regulations provide that a foreign tax is treated as being paid by "the person on whom foreign law imposes legal liability for such tax."[441] Thus, for example, if a U.S. corporation owns an interest in a foreign partnership, the U.S. corporation can claim foreign tax credits for the tax that is imposed on it as a partner in the foreign entity. This would be true under the regulations even if the U.S. corporation elected to treat the foreign entity as a corporation for U.S. tax purposes. In such a case, if the foreign entity does not meet the definition of a controlled foreign corporation or does not generate income that is subject to current inclusion under the rules of subpart F, the income generated by the foreign entity might never be reported on a U.S. return, and yet the U.S. corporation might take the position that it can claim credits for taxes imposed on that income. This is one

[440] Under the provision, a contingent convertible debt instrument is defined as a debt instrument that: (1) is convertible into stock of the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation; and (2) provides for contingent payments.

[441] Treas. Reg. sec. 1.901–2(f)(1).

example of how a taxpayer might attempt to separate foreign taxes from the related foreign income, and thereby attempt to claim a foreign tax credit under circumstances in which there is no threat of double taxation.

The Treasury Department currently has the authority to promulgate regulations under section 901 and other provisions of the Code to address transactions and structures that produce inappropriate foreign tax credit results.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment enhances the regulatory authority of the Treasury Department to address transactions that involve the inappropriate separation of foreign taxes from the related foreign income or in which foreign taxes are imposed on any person in respect of income of another person. This grant of regulatory authority supplements existing Treasury Department authority and thereby provide greater flexibility in addressing a wide range of transactions and structures. Regulations issued pursuant to this authority could, for example, provide for the disallowance of a credit for all or a portion of the foreign taxes, or for the allocation of the foreign taxes among the participants in the transaction in a manner more consistent with the economics of the transaction.

Effective date.—The provision generally is effective for transactions entered into after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision. No inference is intended as to the scope of the Treasury Department's existing regulatory authority to address transactions that involve the inappropriate separation of foreign taxes from the related foreign income.

3. Modifications of effective dates of leasing provisions of the American Jobs Creation Act of 2004 (sec. 453 of the Senate amendment and sec. 470 of the Code)

PRESENT LAW

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

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment makes two changes to the effective date of the loss deferral rules. First, the Senate amendment repeals the qualified transportation property exception. Second, the Senate amendment applies the loss deferral rules to leases entered into on or before March 12, 2004, if the lessee is a foreign person or entity. With respect to such leases, losses are deferred starting in taxable years beginning after December 31, 2005.

Effective date.—The Senate amendment is effective as if included in the provisions of the American Jobs Creation Act of 2004, Pub. L. No. 108–357 (2004), to which it relates.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

4. Application of earnings stripping rules to partners which are corporations (sec. 454 of the Senate amendment and sec. 163 of the Code)

PRESENT LAW

Present law provides rules to limit the ability of U.S. corporations to reduce the U.S. tax on their U.S.-source income through earnings stripping transactions. Section 163(j) specifically addresses earnings stripping involving interest payments, by limiting the deductibility of interest paid to certain related parties ("disqualified interest"),[442] if the payor's debt-equity ratio exceeds 1.5 to 1 and the payor's net interest expense exceeds 50 percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization, and depletion). Disallowed interest amounts can be carried forward indefinitely. In addition, excess limitation (i.e., any excess of the 50-percent limit over a company's net interest expense for a given year) can be carried forward three years.

Proposed Treasury regulations provide that a partner's proportionate share of partnership liabilities is treated as liabilities incurred directly by the partner, for purposes of applying the earnings stripping limitation to interest payments by a corporate partner of a partnership.[443] The proposed Treasury regulations provide that interest paid or accrued to a partnership is treated as paid or accrued to the partners of the partnership in proportion to each partner's distributive share of the partnership's interest income for the taxable year.[444] In addition, the proposed Treasury regulations provide that interest expense paid or accrued by a partnership is treated as paid or accrued by the partners of the partnership in

[442] This interest also may include interest paid to unrelated parties in certain cases in which a related party guarantees the debt.
[443] Prop. Treas. Reg. sec. 1.163(j)–3(b)(3).
[444] Prop. Treas. Reg. sec. 1.163(j)–2(e)(4).

proportion to each partner's distributive share of the partnership's interest expense.[445]

HOUSE BILL

No provision.

SENATE AMENDMENT

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

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

Effective date.—The provision is effective for taxable years beginning on or after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement includes the Senate amendment provision.

5. Limitation on employer deduction for certain entertainment expenses (sec. 455 of the Senate amendment and sec. 274(e) of the Code)

PRESENT LAW

In general

Under present law, no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement or recreation, unless the taxpayer establishes that the item was directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business, or (2) a facility (*e.g.*, an airplane) used in connection with such activity.[446] The Code includes a number of exceptions to the general rule disallowing deductions of entertainment expenses. Under one exception, the deduction disallowance rule does not apply to expenses for goods, services, and facilities to the extent that the expenses are reported by the taxpayer as compensation and wages to an employee.[447] The

[445] Prop. Treas. reg. sec. 1.163(j)–2(e)(5).
[446] Sec. 274(a).
[447] Sec. 274(e)(2). As discussed below, a special rule applies in the case of specified individuals.

deduction disallowance rule also does not apply to expenses paid or incurred by the taxpayer for goods, services, and facilities to the extent that the expenses are includible in the gross income of a recipient who is not an employee (*e.g.,* a nonemployee director) as compensation for services rendered or as a prize or award.[448] The exceptions apply only to the extent that amounts are properly reported by the company as compensation and wages or otherwise includible in income. In no event can the amount of the deduction exceed the amount of the actual cost, even if a greater amount is includible in income.

Except as otherwise provided, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. In general, an employee or other service provider must include in gross income the amount by which the fair value of a fringe benefit exceeds the amount paid by the individual. Treasury regulations provide rules regarding the valuation of fringe benefits, including flights on an employer-provided aircraft.[449] In general, the value of a non-commercial flight is determined under the base aircraft valuation formula, also known as the Standard Industry Fare Level formula or "SIFL".[450] If the SIFL valuation rules do not apply, the value of a flight on a company-provided aircraft is generally equal to the amount that an individual would have to pay in an arm's-length transaction to charter the same or a comparable aircraft for that period for the same or a comparable flight.[451]

In the context of an employer providing an aircraft to employees for nonbusiness (*e.g.,* vacation) flights, the exception for expenses treated as compensation was interpreted in Sutherland Lumber-Southwest, Inc. v. Commissioner ("Sutherland Lumber") as not limiting the company's deduction for operation of the aircraft to the amount of compensation reportable to its employees,[452] which can result in a deduction many times larger than the amount required to be included in income. In many cases, the individual including amounts attributable to personal travel in income directly benefits from the enhanced deduction, resulting in a net deduction for the personal use of the company aircraft.

Specified individuals

In the case of specified individuals, the exceptions to the general entertainment expense disallowance rule for expenses treated as compensation or includible in income apply only to the extent of the amount of expenses treated as compensation or includible in income of the specified individual. For example, a company's deduction attributable to aircraft operating costs and other expenses for a specified individual's vacation use of a company aircraft is limited to the amount reported as compensation to the specified individual. Sutherland Lumber is thus overturned with respect to specified individuals.

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[448] Sec. 274(e)(9).
[449] Treas. Reg. sec. 1.61–21.
[450] Treas. Reg. sec. 1.61–21(g).
[451] Treas. Reg. sec. 1.61–21(b)(6).
[452] *Sutherland Lumber-Southwest, Inc.* v. *Comm.*, 114 T.C. 197 (2000), aff'd, 255 F.3d 495 (8th Cir. 2001), acq., AOD 2002–02 (Feb. 11, 2002).

Specified individuals are individuals who, with respect to an employer or other service recipient (or a related party), are subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934, or would be subject to such requirements if the employer or service recipient (or the related party) were an issuer of equity securities referred to in section 16(a).[453] Such individuals generally include officers (as defined by section 16(a)),[454] directors, and 10-percent-or-greater owners of private and publicly-held companies.

HOUSE BILL

No provision.

SENATE AMENDMENT

Under the Senate amendment, in the case of all individuals, the exceptions to the general entertainment expense disallowance rule for expenses treated as compensation or includible in income apply only to the extent of the amount of expenses treated as compensation or includible in income. Thus, under those exceptions, no deduction is allowed with respect to expenses for (1) a nonbusiness activity generally considered to be entertainment, amusement or recreation, or (2) a facility (e.g., an airplane) used in connection with such activity to the extent that such expenses exceed the amount treated as compensation or includible in income. The provision is intended to overturn Sutherland Lumber for all individuals. As under present law, the exceptions apply only if amounts are properly reported by the company as compensation and wages or otherwise includible in income.

Effective date.—The provision is effective for expenses incurred after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

6. Increase in age of minor children whose unearned income is taxed as if parent's income (sec. 456 of the Senate amendment and sec. 1(g) of the Code)

PRESENT LAW

Filing requirements for children

A single unmarried individual eligible to be claimed as a dependent on another taxpayer's return generally must file an individual income tax return if he or she has: (1) earned income only over $5,150 (for 2006); (2) unearned income only over the minimum standard deduction amount for dependents ($850 in 2006); or (3) both earned income and unearned income totaling more than the

[453] For purposes of this definition, a person is a related party with respect to another person if such person bears a relationship to such other person described in section 267(b) or 707(b).

[454] An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

smaller of (a) $5,150 (for 2006) or (b) the larger of (i) $850 (for 2006), or (ii) earned income plus $300.[455] Thus, if a dependent child has less than $850 in gross income, the child does not have to file an individual income tax return for 2006.[456]

A child who cannot be claimed as a dependent on another person's tax return is subject to the generally applicable filing requirements. Such a child generally must file a return if the individual's gross income exceeds the sum of the standard deduction and the personal exemption amount ($3,300 for 2006).

Taxation of unearned income under section 1(g)

Special rules (generally referred to as the "kiddie tax") apply to the unearned income of a child who is under age 14.[457] The kiddie tax applies if: (1) the child has not reached the age of 14 by the close of the taxable year; (2) the child's unearned income was more than $1,700 (for 2006); and (3) the child is required to file a return for the year. The kiddie tax applies regardless of whether the child may be claimed as a dependent on the parent's return.

For these purposes, unearned income is income other than wages, salaries, professional fees, or other amounts received as compensation for personal services actually rendered.[458] For children under age 14, net unearned income (for 2006, generally unearned income over $1,700) is taxed at the parent's rate if the parent's rate is higher than the child's rate. The remainder of a child's taxable income (i.e., earned income, plus unearned income up to $1,700 (for 2006), less the child's standard deduction) is taxed at the child's rates, regardless of whether the kiddie tax applies to the child. In general, a child is eligible to use the preferential tax rates for qualified dividends and capital gains.[459]

The kiddie tax is calculated by computing the "allocable parental tax." This involves adding the net unearned income of the child to the parent's income and then applying the parent's tax rate. A child's "net unearned income" is the child's unearned income less the sum of (1) the minimum standard deduction allowed to dependents ($850 for 2006), and (2) the greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized deductions that are directly connected with the production of the unearned income.[460] A child's net unearned income cannot exceed the child's taxable income.

The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parent's taxable income. If the child has net capital gains or qualified dividends, these items are allocated to the par-

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[455] Sec. 6012(a)(1)(C). Other filing requirements apply to dependents who are married, elderly, or blind. See, Internal Revenue Service, Publication 929, Tax Rules for Children and Dependents, at 2, Table 1 (2005).

[456] A taxpayer generally need not file a return if he or she has gross income in an amount less than the standard deduction (and, if allowable to the taxpayer, the personal exemption amount). An individual who may be claimed as a dependent of another taxpayer is not eligible to claim the dependency exemption relating to that individual. Sec. 151(d)(2). For taxable years beginning in 2006, the standard deduction amount for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of $850 or the sum of $300 and the individual's earned income.

[457] Sec. 1(g).

[458] Sec. 1(g)(4) and sec. 911(d)(2).

[459] Sec. 1(h).

[460] Sec. 1(g)(4).

ent's hypothetical taxable income according to the ratio of net unearned income to the child's total unearned income. If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase, based upon the child's net unearned income relative to the aggregate net unearned income of all of the parent's children subject to the tax.

Special rules apply to determine which parent's tax return and rate is used to calculate the kiddie tax. If the parents file a joint return, the allocable parental tax is calculated using the income reported on the joint return. In the case of parents who are married but file separate returns, the allocable parental tax is calculated using the income of the parent with the greater amount of taxable income. In the case of unmarried parents, the child's custodial parent is the parent whose taxable income is taken into account in determining the child's liability. If the custodial parent has remarried, the stepparent is treated as the child's other parent. Thus, if the custodial parent and stepparent file a joint return, the kiddie tax is calculated using that joint return. If the custodial parent and stepparent file separate returns, the return of the one with the greater taxable income is used. If the parents are unmarried but lived together all year, the return of the parent with the greater taxable income is used.[461]

Unless the parent elects to include the child's income on the parent's return (as described below) the child files a separate return to report the child's income.[462] In this case, items on the parent's return are not affected by the child's income. The total tax due from a child is the greater of:

1. the sum of (a) the tax payable by the child on the child's earned income and unearned income up to $1,700 (for 2006), plus (b) the allocable parental tax on the child's unearned income, or

2. the tax on the child's income without regard to the kiddie tax provisions.

Parental election to include child's dividends and interest on parent's return

Under certain circumstances, a parent may elect to report a child's dividends and interest on the parent's return. If the election is made, the child is treated as having no income for the year and the child does not have to file a return. The parent makes the election on Form 8814, Parents' Election to Report Child's Interest and Dividends. The requirements for the parent's election are that:

1. the child has gross income only from interest and dividends (including capital gains distributions and Alaska Permanent Fund Dividends);[463]

2. such income is more than the minimum standard deduction amount for dependents ($850 in 2006) and less than 10 times that amount ($8500 in 2006);

[461] Sec. 1(g)(5); Internal Revenue Service, Publication 929, Tax Rules for Children and Dependents, at 6 (2005).

[462] The child must attach to the return Form 8615, Tax for Children Under Age 14 With Investment Income of More Than $1,700 (2006).

[463] Internal Revenue Service, Publication 929, Tax Rules for Children and Dependents, at 6 (2005).

3. no estimated tax payments for the year were made in the child's name and taxpayer identification number;

4. no backup withholding occurred; and

5. the child is required to file a return if the parent does not make the election.

Only the parent whose return must be used when calculating the kiddie tax may make the election. The parent includes in income the child's gross income in excess of twice the minimum standard deduction amount for dependents (i.e., the child's gross income in excess of $1,700 for 2007). This amount is taxed at the parent's rate. The parent also must report an additional tax liability equal to the lesser of: (1) $85 (in 2006), or (2) 10 percent of the child's gross income exceeding the child's standard deduction ($850 in 2006).

Including the child's income on the parent's return can affect the parent's deductions and credits that are based on adjusted gross income, as well as income-based phaseouts, limitations, and floors.[464] In addition, certain deductions that the child would have been entitled to take on his or her own return are lost.[465] Further, if the child received tax-exempt interest from a private activity bond, that item is considered a tax preference of the parent for alternative minimum tax purposes.[466]

Taxation of compensation for services under section 1(g)

Compensation for a child's services is considered the gross income of the child, not the parent, even if the compensation is not received or retained by the child (e.g. is the parent's income under local law).[467] If the child's income tax is not paid, however, an assessment against the child will be considered as also made against the parent to the extent the assessment is attributable to amounts received for the child's services.[468]

HOUSE BILL

No provision.

SENATE AMENDMENT

The provision increases the age to which the kiddie tax provisions apply from under 14 to under 18 years of age. The provision also creates an exception to the kiddie tax for distributions from certain qualified disability trusts, defined by cross-reference to sections 1917 and 1614(a)(3) of the Social Security Act.

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

CONFERENCE AGREEMENT

The conference agreement includes the Senate amendment provision with one modification. This modification provides that the

[464] Internal Revenue Service, Publication 929, Tax Rules for Children and Dependents, at 7 (2005).

[465] Internal Revenue Service, Publication 929, Tax Rules for Children and Dependents, at 7 (2005).

[466] Sec. 1(g)(7)(B).

[467] Sec. 73(a).

[468] Sec. 6201(c).

kiddie tax does not apply to a child who is married and files a joint return for the taxable year.

7. Impose loan and redemption requirements on pooled financing bonds (sec. 457 of the Senate amendment and sec. 149 of the Code)

PRESENT LAW

In general

Interest on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes if the proceeds of such bonds are used to finance direct activities of governmental units or if such bonds are repaid with revenues of governmental units. These bonds are called "governmental bonds." Interest on State or local government bonds issued to finance activities of private persons is taxable unless a specific exception applies. These bonds are called "private activity bonds." The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes. In addition, the Code imposes qualification requirements that apply to all State and local bonds. Arbitrage restrictions, for example, limit the ability of issuers to profit from investment of tax-exempt bond proceeds. The Code also imposes requirements that only apply to specific types of bond issues. For instance, pooled financing bonds (defined below) are not tax-exempt unless the issuer meets certain requirements regarding the expected use of proceeds.

Pooled financing bond restrictions

State or local governments also issue bonds to provide financing for the benefit of a third party (a "conduit borrower"). Pooled financing bonds are bond issues that are used to make or finance loans to two or more conduit borrowers, unless the conduit loans are to be used to finance a single project.[469] The Code imposes several requirements on pooled financing bonds if more than $5 million of proceeds are expected to be used to make loans to conduit borrowers. For purposes of these rules, a pooled financing bond does not include certain private activity bonds.[470]

A pooled financing bond is not tax-exempt unless the issuer reasonably expects that at least 95 percent of the net proceeds will be lent to ultimate borrowers by the end of the third year after the date of issue. The term "net proceeds" is defined to mean the proceeds of the issue less the following amounts: 1) proceeds used to finance issuance costs; 2) proceeds necessary to pay interest on the bonds during a three-year period; and 3) amounts in reasonably required reserves.[471]

An issuer's past experience regarding loan origination is a criterion upon which the reasonableness of the issuer's expectations can be based. As an additional requirement for tax exemption, all legal and underwriting costs associated with the issuance of pooled

[469] Treas. Reg. sec. 1.150–1(b).
[470] Sec. 149(f)(4)(B).
[471] Sec. 149(f)(2)(C).

financing bonds may not be contingent and must be substantially paid within 180 days of the date of issuance.

Arbitrage restrictions on tax-exempt bonds

To prevent the issuance of more Federally subsidized tax-exempt bonds than necessary; the tax exemption for State and local bonds does not apply to any arbitrage bond.[472] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments. In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods") before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, investment profits that are earned during these periods or on such investments must be rebated to the Federal Government ("arbitrage rebate").

The Code contains several exceptions to the arbitrage rebate requirement, including an exception for bonds issued by small governments (the "small issuer exception"). For this purpose, small governments are defined as general purpose governmental units that issue no more than $5 million of tax-exempt governmental bonds in a calendar year.[473]

Pooled financing bonds are subject to the arbitrage restrictions that apply to all tax-exempt bonds, including arbitrage rebate. Under certain circumstances, however, small governments may issue pooled financing bonds without those bonds counting towards the determination of whether the issuer qualifies for the small issuer exception to arbitrage rebate. In the case of a pooled financing bond where the ultimate borrowers are governmental units with general taxing powers not subordinate to the issuer of the pooled bond, the pooled bond does not count against the issuer's $5 million limitation, provided the issuer is not a borrower from the pooled bond.[474] However, the issuer of the pooled financing bond remains subject to the arbitrage rebate requirement for unloaned proceeds.[475]

HOUSE BILL

No provision.

SENATE AMENDMENT

In general

The provision imposes new requirements on pooled financing bonds as a condition of tax-exemption. First, the provision imposes a written loan commitment requirement to restrict the issuance of pooled bonds where potential borrowers have not been identified ("blind pools"). Second, in addition to the current three-year expectations requirement, the issuer must reasonably expect that at

[472] Secs. 103(a) and (b)(2).
[473] The $5 million limit is increased to $15 million if at least $10 million of the bonds are used to finance public schools.
[474] Sec. 148(f)(4)(D)(ii)(II).
[475] Treas. Reg. sec. 1.148–8(d)(1).

least 50 percent of the net proceeds of the pooled bond will be lent to borrowers one year after the date of issue. Third, the provision requires the redemption of outstanding bonds with proceeds that are not loaned to borrowers within the expected loan origination periods. Finally, the provision eliminates the rule allowing an issuer of pooled financing bonds to disregard the pooled bonds for purposes of determining whether the issuer qualifies for the small issuer exception to rebate.

Borrower identification

Under the provision, interest on a pooled financing bond is tax exempt only if the issuer obtains written commitments with ultimate borrowers for loans equal to at least 50 percent of the net proceeds of the pooled bond prior to issuance. The loan commitment requirement does not apply to bonds issued by States (or an integral part of a State) to provide loans to subordinate governmental units or State entities created to provide financing for water-infrastructure projects through the federally-sponsored State revolving fund program.

Loan origination expectations

The provision imposes new reasonable expectations requirements for loan originations. The issuer must expect that at least 50 percent of the net proceeds of a pooled financing bond will be lent to ultimate borrowers one year after the date of issue. This is in addition to the present-law requirement that at least 95 percent of the net proceeds will be lent to ultimate borrowers by the end of the third year after the date of issue.

Redemption requirement

Under the provision, if bond proceeds are not loaned to borrowers within prescribed periods, outstanding bonds equal to the amount of proceeds that were not loaned within the required period must be redeemed with 90 days. The bond redemption requirement applies with respect to proceeds that are unloaned as of expiration of the one-year and three-year loan origination periods. For example, if an amount equal to 45 percent of the net proceeds of an issue are used to make loans to ultimate borrowers as of one year after the bonds are issued, an amount equal to five percent of the net proceeds of the issue is no longer available for lending and must be used to redeem bonds within the following six-month period. Similarly, if only 85 percent of the net proceeds of the issue are used to make qualifying loans (or to redeem bonds) as of three years after the bonds are issued, 10 percent of the remaining net proceeds is no longer available for lending and must be used to redeem bonds within the following six months.

Small issuer exception

The provision eliminates the rule disregarding pooled financing bonds from the issuer's $5,000,000 annual limitation for purposes of the small issuer exception to arbitrage rebate.

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

CONFERENCE AGREEMENT

The conference agreement includes the Senate amendment provision, with the following modifications.

Under the conference agreement, issuers of pooled financing bonds must reasonably expect that at least 30 percent of the net proceeds of such bonds will be loaned to ultimate borrowers one year after the date of issue. The present-law requirement that issuers must reasonably expect to loan at least 95 percent of the net proceeds of a pooled financing bond to ultimate borrowers three years after the date of issue is unchanged. Bond proceeds that are not loaned to borrowers as required under the one- and three-year rules must be used to redeem outstanding bonds within 90 days of the expiration of such one- and three-year periods.

The conference agreement requires issuers of pooled financing bonds to obtain, prior to issuance, written commitments from borrowers equal to at least 30 percent of the net proceeds of the pooled financing bond. The conference agreement includes the Senate amendment's exception to the written loan commitment requirement. Thus, the loan commitment requirement does not apply to pooled financing bonds issued by States (or an integral part of a State) to provide loans to subordinate governmental units or State entities created to provide financing for water-infrastructure projects through the federally-sponsored State revolving fund program.

8. Amend information reporting requirements to include interest on tax-exempt bonds (sec. 458 of the Senate amendment and sec. 6049 of the Code)

PRESENT LAW

Tax-exempt bonds

Generally, gross income does not include interest on State or local bonds.[476] State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental facilities or the debt is repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain purposes ("qualified private activity bonds") permitted by the Code.[477]

Tax-exempt interest reporting by taxpayers

The Code provides that every person required to file a return must report the amount of tax-exempt interest received or accrued during any taxable year.[478] There are a number of reasons why the amount of tax-exempt interest received is relevant to determining tax liability despite the general exclusion from income. For example, the interest income from qualified private activity bonds (other

[476] Sec. 103.
[477] Secs. 103(b)(1) and 141.
[478] Sec. 6012(d).

than qualified 501(c)(3) bonds) issued after August 7, 1986, is a preference item for purposes of calculating the alternative minimum tax ("AMT").[479] Tax-exempt interest also is relevant for determining eligibility for the earned income credit (the "EIC")[480] and the amount of Social Security benefits includable in gross income.[481] Moreover, determining includable Social Security benefits is necessary for calculating either adjusted or modified adjusted gross income under several Code sections.[482]

Information reporting by payors

The Code generally requires every person who makes payments of interest aggregating $10 or more or receives payments of interest as a nominee and who makes payments aggregating $10 or more to file an information return setting forth the amount of interest payments for the calendar year and the name, address, and TIN[483] of the person to whom interest is paid.[484] Treasury regulations prescribe the form and manner for filing interest payment information returns. Penalties are imposed for failures to file interest payment information returns or payee statements.[485] Treasury Regulations also impose recordkeeping requirements on any person required to file information returns.[486] The Code excludes interest paid on tax-exempt bonds from interest reporting requirements.[487]

HOUSE BILL

No provision.

SENATE AMENDMENT

The provision eliminates the exception from information reporting requirements for interest paid on tax-exempt bonds.

Effective date.—The provision is effective for interest paid on tax-exempt bonds after December 31, 2005.

CONFERENCE AGREEMENT

The conference agreement includes the Senate amendment provision.

9. Modification of credit for fuel from a non-conventional source (sec. 459 of the Senate amendment 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

[479] Sec. 57(a)(5). Special rules apply to exclude refundings of bonds issued before August 8, 1986, and certain bonds issued before September 1, 1986.
[480] Sec. 32(i).
[481] Sec. 86.
[482] See Secs. 135, 219, and 221.
[483] The taxpayer's identification number, generally, for individuals is the taxpayer's social security number. Sec. 7701(a)(41).
[484] Sec. 6049.
[485] Secs. 6721 and 6722.
[486] Treas. Reg. sec. 1.6001–1(a).
[487] Sec. 6049.

to $3 (generally adjusted for inflation)[488] per barrel or Btu oil barrel equivalent ("non- conventional source fuel credit").[489] 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 producing coke or coke gas at qualified facilities placed in service before 1993 or after June 30, 1998, and before 2010. The coke production credit is available for coke or coke gas produced over the four-year period beginning on January 1, 2006, or the date the facility was placed in service, if later. 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 2004 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).

HOUSE BILL

No provision.

SENATE AMENDMENT

The provision modifies the manner in which the phase-out of the non-conventional source fuel credit is calculated. Specifically, in calculating the phase-out of the credit rather than relying upon the reference price for the calendar year in which the sale of qualified non-conventional fuel occurs, the provision uses the reference price for the calendar year preceding the calendar year in which the sale occurs. Thus, under the provision, whether the credit is phased out in 2005 is determined by reference to 2004 wellhead prices, whether the credit is phased out in 2006 is determined by reference to 2005 wellhead prices, and so on. In addition, the provision repeals

[488] 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. The credit for coke or coke gas is indexed for inflation using 2004 as the base year instead of 1979.

[489] Sec. 29 (for tax years ending before 2006); sec. 45K (for tax years ending after 2005).

the phase-out limitation entirely for coke and coke gas produced under section 45K(g).

The provision eliminates the inflation adjustment for all fuels other than coke and coke gas for 2005, 2006, and 2007. Thus, the current credit amount of $6.79 per barrel of oil equivalent would be retroactively reduced to $6.56 per barrel of oil equivalent, and that reduced amount would remain in effect through the December 31, 2007. Under the provision, the credit amount of $3 per barrel of oil equivalent for coke and coke gas produced under section 45K(g) would continue to be adjusted for inflation using 2004 as the base year.

Finally, the provision 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.

Effective date.—The provision applies to fuel sold after December 31, 2004.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

10. Modification of individual estimated tax safe harbor (sec. 460 of the Senate Amendment and sec. 6654 of the Code)

PRESENT LAW

An individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments equal to the lesser of: (1) 90 percent of the tax shown on the current year's return or (2) 100 percent of the prior year's tax. For individuals with a prior year's AGI above $150,000, however, the rule that allows payment of 100 percent of prior year's tax is modified. Individuals with prior-year AGI above $150,000 generally must make estimated payments equal to the lesser of (1) 90 percent of the tax shown on the current year's return or (2) 110 percent of the tax shown on the prior year's return.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment provides that individuals with prior year's AGI above $150,000 who make estimated tax payments based on prior year's tax must do so based on 120 percent of the tax shown on the prior year's return, for estimated tax payments for taxable years beginning in 2006. That percentage will revert back to 110 percent for taxable years beginning after 2006.

Effective date.—The provision is effective for estimated tax payments for taxable years beginning after December 31, 2005.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

11. Revaluation of LIFO inventories of large integrated oil companies (sec. 461 of the Senate amendment)

PRESENT LAW

A taxpayer is generally permitted to use a last-in, first-out (LIFO) method to inventory goods, on the condition that the taxpayer also uses the LIFO method in reporting to shareholders, partners, other proprietors, and beneficiaries, and for credit purposes.[490] Under the LIFO method, a taxpayer (i) treats goods on hand at the close of the taxable year as being: first, those goods included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof; and second, those acquired in the taxable year; (ii) inventories the goods at cost; and (iii) treats those goods included in the opening inventory of the taxable year in which the LIFO method was first used as having been acquired at the same time, and determines their cost by the average cost method.[491]

In periods during which a taxpayer produces or purchases more goods than the taxpayer sells (such excess, an "inventory increment"), a LIFO method taxpayer generally records the inventory cost of such excess (and separately tracks such amount as the "LIFO layer" for such period), adds it to the cost of inventory at the start of the period, and carries such total inventory cost forward to the beginning inventory of the following year.

In periods during which the taxpayer sells more goods than the taxpayer produces or purchases (such decrease, an "inventory decrement"), a LIFO method taxpayer generally determines the cost of goods sold of the amount of the decrement by treating such sales as occurring out of the most recent LIFO layer (or the most recent LIFO layers, if the amount of the decrement exceeds the amount of inventory in the most recent LIFO layer) in reverse chronological order.

HOUSE BILL

No provision.

SENATE AMENDMENT

The provision disallows a portion of the benefit of the LIFO method to integrated oil companies[492] which have an average daily production of crude oil of at least 500,000 barrels of oil and which have in excess of $1 billion for the last taxable year ending during 2005.

Specifically, the provision requires such taxpayers to revalue each historic LIFO layer of crude oil inventories by adding to each layer an amount equal to $18.75 multiplied by the number of bar-

[490] Sec. 472(c).
[491] Sec. 472.
[492] The provision defines an "integrated oil company" by cross-reference to section 291(b)(4), which generally includes retailers and large refiners of oil or natural gas or any product derived from oil or natural gas.

rels of crude oil represented by such LIFO layer; the taxpayer must reduce its cost of sales for such taxable year by a like amount.

For example, suppose a taxpayer, which is an integrated oil company with average daily production of at least 500,000 barrels of oil and revenues in excess of $1 billion, has a 2005 starting inventory of 200x barrels, comprised of a 1955 LIFO layer with 50x barrels valued at $5 per barrel (with a total cost of $250x); a 1985 LIFO layer with 100x barrels valued at $18 per barrel (with a total cost $1800x); a 2000 LIFO layer with 30x barrels valued at $25 per barrel (with a total cost of $750x), and a 2004 LIFO layer with 20x barrels valued at $35 per barrel (with a total cost $700x), for a total inventory value of $3500x. Suppose further that the taxpayer's ending inventory is 200x barrels, i.e., the same as the starting inventory, so the taxpayer has neither an inventory increment nor an inventory decrement for the taxable year.

Under the provision, the taxpayer will revalue each layer upwards by $18.75/barrel. Thus, the taxpayer will increase its 1955 LIFO layer by $937.50x; its 1985 LIFO layer by $1875x; its 2000 LIFO layer by $562.50x; and its 2004 LIFO layer by $375x. The taxpayer will offset this $3750x increase in inventory by reducing by $3750x the taxpayer's cost of goods sold for the last taxable year ending in 2005. In the event the taxpayer's cost of goods sold for such taxable year prior to such reduction is less than $3750x, the taxpayer will reduce its cost of goods sold to zero and increase its gross income for such taxable year by such difference.

Effective date.—The provision is effective for the last taxable year of a taxpayer ending in 2005.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

12. Amortization of geological and geophysical expenditures (sec. 462 of the Senate amendment and sec. 167(h) of the Code)

PRESENT LAW

Geological and geophysical expenditures ("G&G costs") are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals. G&G costs incurred in connection with oil and gas exploration in the United States may be amortized over two years.[493] In the case of abandoned property, remaining basis may not be recovered in the year of abandonment of a property as all basis is recovered over the two-year amortization period.

HOUSE BILL

No provision.

SENATE AMENDMENT

The provision repeals the two-year amortization period with respect to G&G costs paid or incurred by certain large integrated oil

[493] Sec. 167(h).

companies, defined to include integrated oil companies (as defined in section 291(b)(4) of the Code) that have an average daily worldwide production of crude oil of at least 500,000 barrels. Thus, affected oil companies are required to capitalize their G&G costs associated with successful exploration projects that result in the acquisition of property. Such companies can recover any G&G costs associated with abandoned property in the year of abandonment.

Effective date.—The provision is effective for G&G costs paid or incurred in taxable years beginning after August 8, 2005.

CONFERENCE AGREEMENT

The conference agreement extends the two-year amortization period for G&G costs to five years for certain major integrated oil companies. Under the conference agreement, the five-year amortization rule for G&G costs applies only to integrated oil companies that have an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year, gross receipts in excess of $1 billion in the last taxable year ending during calendar year 2005, and an ownership interest in a crude oil refiner of 15 percent or more.

Effective date.—The provision applies to amounts paid or incurred after the date of enactment.

13. Valuation of employee personal use of noncommercial aircraft (sec. 463 of the Senate amendment)

PRESENT LAW

Unless an exception applies, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. In general, an employee or other service provider must include in gross income the amount by which the fair value of a fringe benefit exceeds the amount paid by the individual. Treasury regulations provide rules regarding the valuation of fringe benefits, including flights on an employer-provided aircraft.[494] In general, the value of a non-commercial flight is determined under the base aircraft valuation formula, also known as the Standard Industry Fare Level formula or "SIFL".[495] If the SIFL valuation rules do not apply, the value of a flight on a company-provided aircraft is generally equal to the amount that an individual would have to pay in an arm's-length transaction to charter the same or a comparable aircraft for that period for the same or a comparable flight.[496]

HOUSE BILL

No provision.

SENATE AMENDMENT

Under the Senate amendment, for purposes of income inclusion, the value of any employee personal use of noncommercial aircraft is equal to the excess of (1) the greater of the fair market

[494] Treas. Reg. sec. 1.61–21.
[495] Treas. Reg. sec. 1.61–21(g).
[496] Treas. Reg. sec. 1.61–21(b)(6).

value of such use or actual cost of such use (including all fixed and variable costs), over (2) the amount paid by or on behalf of the employee for such use. Thus, the SIFL valuation rules may no longer be used to determine the value of such use.

Effective date.—The provision applies to use after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

14. Application of Foreign Investment in Real Property Tax Act ("FIRPTA") to Regulated Investment Companies ("RICs") (sec. 464 of the Senate amendment and sec. 897(h)(4) of the Code)

In general

A nonresident alien individual or foreign corporation is taxable on its taxable income which is effectively connected with the conduct of a trade or business within the United States, at the income tax rates applicable to U.S. persons. A nonresident alien individual is taxed (at a 30-percent rate) on gains, derived from sources within the United States, from the sale or exchange of capital assets if the individual is present in the United States for 183 days or more during the taxable year.

In addition, the Foreign Investment in Real Property Tax Act (FIRPTA)[497] generally treats a nonresident alien individual or foreign corporation's gain or loss from the disposition of a U.S. real property interest (USRPI) as income that is effectively connected with a U.S. trade or business, and thus taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. A foreign investor subject to tax on this income is required to file a U.S. income tax return under the normal rules relating to receipt of income effectively connected with a U.S. trade or business.

The payor of FIRPTA effectively connected income to a foreign person is generally required to withhold U.S. tax from the payment. Withholding is generally 10 percent of the sales price in the case of a direct sale by the foreign person of a USRPI, and 35 percent of the amount of a distribution to a foreign person of proceeds attributable to such sales from an entity such as a partnership.[498] The foreign person can request a refund with its U.S. tax return, if appropriate based on that person's total U.S. effectively connected income and deductions (if any) for the taxable year.

USRPIs include interests in real property located in the United States or the U.S. Virgin Islands, and stock of a domestic U.S. real

[497] FIRPTA is codified in section 897 of the Code.

[498] Sec. 1445 and Treasury regulations thereunder. The Treasury department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 15 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 15 percent.

Section 1445 statutorily requires the 10 percent withholding by the purchaser of a USRPI and the 35 percent withholding (or less if directed by Treasury) on certain distributions by partnerships, trusts, and estates, among other situations. Treasury regulations prescribe the 35 percent withholding requirement for distributions by REITs to foreign shareholders. Treas. Reg. sec. 1.1445–8. No regulations have been issued relating specifically to RIC distributions, which first became subject to FIRPTA in 2005.

property holding company (USRPHC), generally defined as any corporation, unless the taxpayer established that the fair market value of its U.S. real property interests is less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and of all its assets used or held for use in a trade or business.[499] However, any class of stock that is regularly traded on an established securities market located in the U.S. is treated as a U.S. real property interest only if the seller held more than 5 percent of the stock at any time during the 5-year period ending on the date of disposition of the stock.[500]

Special rules for certain investment entities

Real estate investment trusts and regulated investment companies are generally passive investment entities. They are organized as U.S. domestic entities and are taxed as U.S. domestic corporations. However, because of their special status, they are entitled to deduct amounts distributed to shareholders and, in some cases, to allow the shareholders to characterize these amounts based on the type of income the REIT or RIC received. Among numerous other requirements for qualification as a REIT or RIC, the entity is required to distribute to shareholders at least 90 percent of its income (excluding net capital gain) annually.[501] A REIT or RIC may designate a capital gain dividend to its shareholders, who then treat the amount designated as capital gain.[502] A REIT or RIC is taxed at regular corporate rates on undistributed income; but the combination of the requirement to distribute income other than net capital gain, plus the ability to declare a capital gain dividend and avoid corporate level tax on such income, can result in little, if any, corporate level tax paid by a REIT or RIC. Instead, the shareholder-level tax on distributions is the principal tax paid with respect to income of these entities. The requirements for REIT eligibility include primary investment in real estate assets (which assets can include mortgages). The requirements for RIC eligibility include primary investment in stocks and securities (which can include stock of REITs or of other RICs).

FIRPTA contains special rules for real estate investment trusts (REITs) and regulated investment companies (RICs).[503]

Stock of a "domestically controlled" REIT is not a USRPI. The term "domestically controlled" is defined to mean that less than 50 percent in value of the REIT has been owned by non-U.S. shareholders during the 5-year period ending on the date of disposition.[504] For 2005, 2006, and 2007, a similar exception applies to RIC stock. Thus, stock of a domestically controlled REIT or RIC can be sold without FIRPTA consequences. This exception applies regardless of whether the sale of stock is made directly by a foreign person, or by a REIT or RIC whose distributions to foreign persons of gain attributable to the sale of USRPI's would be subject to FIRPTA as described below.

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[499] Sec. 897(c)(2).
[500] Sec. 897(c)(3).
[501] Secs. 852(a)(1) and 852(b)(2)(A); 857(a)(1).
[502] Secs. 852(b)(3); 857(b)(3).
[503] Sec. 897(h).
[504] Sec. 897(h)(2) and (h)(4)(B).

A distribution by a REIT to a foreign shareholder, to the extent attributable to gain from the REIT's sale or exchange of USRPIs, is generally treated as FIRPTA gain to the shareholder. An exception enacted in 2004 applies if the distribution is made on a class of REIT stock that is regularly traded on an established securities market located in the United States and the foreign shareholder has not held more than 5 percent of the class of stock at any time during the one-year period ending on the date of the distribution.[505] Where the exception applies, the distribution to the foreign shareholder is treated as the distribution of an ordinary dividend (rather than as a capital gain dividend), subject to 30-percent (or lower treaty rate) withholding.[506]

Prior to 2005, distributions by RICs to foreign shareholders, to the extent attributable to the RIC's sale or exchange of USRPIs, were not treated as FIRPTA gain. If distributions were attributable to long-term capital gains, the RIC could designate the distributions as long-term capital gain dividends that would not be subject to any tax to the foreign shareholder, rather than as a regular dividends subject to 30-percent (or lower treaty rate) withholding.[507] For 2005, 2006, and 2007, RICs are subject to the rule that had applied to REITs prior to 2005, i.e., any distribution to a foreign shareholder attributable to gain from the RIC's sale of a USRPI is characterized as FIRPTA gain, without any exceptions.[508]

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment provision provides that distributions by a RIC to foreign shareholders of amounts attributable to the sale of USRPIs are not treated as FIRPTA income unless the RIC itself is a U.S. real property holding corporation (i.e. 50 percent or more of its value is represented by its U.S. real property interests, including investments in U.S. real property holding corporations). In determining whether a RIC is a real property holding company for this purpose, a special rule applies that requires the RIC to include as U.S. real property interests its holdings of RIC or REIT stock if such RIC or REIT is a U.S. real property holding corporation, even if such stock is regularly traded on an established securities market and even if the RIC owns less than 5 percent of such stock. Another special rule requires the RIC to include as U.S. real property interests its interests in any domestically controlled RIC or REIT that is a U.S. real property holding corporation.

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[505] This exception, effective beginning in 2005, was added by section 418 of the American Jobs Creation Act of 2004 ("AJCA"), Pub. L. No. 108–357, and modified by section 403(p) of the Tax Technical Corrections Act of 2005.

[506] Sec. 857(b)(3)(F).

[507] Sec. 852(b)(3)(C); Treas. Reg. sec. 1.1441–3(c)(2)(D).

[508] This requirement for RICs was added by section 411 of the American Jobs Creation Act of 2004 ("AJCA"), in connection with the enactment of other rules that allow RICs to identify certain types of distributions to foreign shareholders, attributable to the RIC's receipt of short-term capital gains or interest income, as distributions to such shareholders of such short-term gains or interest income and thus not taxed to the foreign shareholders, rather than as regular dividends that would be subject to withholding. See Secs. 871(k), 881(e), 1441(c)(12) and 1442(a). All these rules are scheduled to expire at the end of 2007, as is the rule subjecting to FIRPTA all distributions of RIC gain attributable to sales of U.S. real property interests and the rule excepting from FIRPTA a foreign person's sale of stock of a "domestically controlled" RIC.

Effective date.—The provision applies to distributions with respect to taxable years beginning after December 31, 2004.

CONFERENCE AGREEMENT

The conference agreement includes the Senate amendment provision with a clarification to the effective date. Under the clarification, the provision takes effect as if included in the provisions of section 411 of the American Jobs Creation Act of 2004 to which it relates.

15. Treatment of REIT and RIC distributions attributable to FIRPTA gains (secs. 465 and 466 of the Senate amendment and secs. 897, 852, and 871 of the Code)

PRESENT LAW

General treatment of U.S.-source income of foreign investors

Fixed and determinable annual and periodical income

The United States generally imposes a flat 30-percent tax, collected by withholding, on the gross amount of U.S.-source investment income payments, such as interest, dividends, rents, royalties and similar types of fixed and determinable annual and periodical income, to nonresident alien individuals and foreign corporations ("foreign persons").[509] Under treaties, the United States may reduce or eliminate such taxes.

Dividends

Even taking into account U.S. treaties, the tax on a dividend generally is not entirely eliminated. Instead, U.S.-source portfolio investment dividends received by foreign persons generally are subject to U.S. withholding tax at a rate of at least 15 percent.

Interest

Although payments of U.S.-source interest that is not effectively connected with a U.S. trade or business generally are subject to the 30-percent withholding tax, there are exceptions to that rule. For example, interest from certain deposits with banks and other financial institutions is exempt from tax.[510] Original issue discount on obligations maturing in 183 days or less from the date of original issue (without regard to the period held by the taxpayer) is also exempt from tax.[511] An additional exception is provided for certain interest paid on portfolio obligations.[512] Such "portfolio interest" generally is defined as any U.S.-source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (i) on an obligation that satisfies certain registration requirements or specified exceptions thereto (i.e., the obligation is "foreign targeted"), and (ii) that is not received by a 10-percent shareholder.[513] With respect to a registered obligation, a state-

[509] Secs. 871(a), 881, 1441, and 1442.
[510] Secs. 871(i)(2)(A) and 881(d).
[511] Sec. 871(g).
[512] Secs. 871(h) and 881(c).
[513] Secs. 871(h)(3) and 881(c)(3).

ment that the beneficial owner is not a U.S. person is required.[514] This exception is not available for any interest received either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), or by a controlled foreign corporation from a related person.[515] Moreover, this exception is not available for certain contingent interest payments.[516] For 2005, 2006 and 2007, a regulated investment company ("RIC") may designate certain distributions to foreign shareholders that are attributable to the RIC's qualified interest income as non-taxable interest distributions to such foreign persons.[517]

Capital gains

A foreign person generally is not subject to U.S. tax on capital gain, including gain realized on the disposition of stock or securities issued by a U.S. person, unless the gain is effectively connected with the conduct of a trade or business in the United States or such person is an individual present in the United States for a period or periods aggregating 183 days or more during the taxable year.[518] A regulated investment company (RIC) can generally designate dividends to foreign persons that are attributable to the RIC's long term capital gain as a long-term gain dividends that are not subject to withholding.[519] For 2005, 2006 and 2007, RICs may also designate short-term capital gain dividends.[520]

For the years 2005, 2006 and 2007, RIC capital gain dividends that are attributable to the sale of U.S. real property interests (which can include stock of companies that are U.S. real property holding companies) are subject to special rules described below.

Real estate investment trusts (REITs) can also designate long-term capital gain dividends to shareholders; but when made to a foreign person such distributions attributable to the sale of U.S. real property interests are also subject to the special rules described below.

Foreign Investment in Real Property Tax Act ("FIRPTA")

Unlike most other U.S. source capital gains, which are generally not taxed to a foreign investor, the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) subjects gain or loss of a foreign person from the disposition of a U.S. real property interest (USRPI) to tax as if the taxpayer were engaged in a trade or business within the United States and the gain or loss were effectively connected with such trade or business.[521] In addition to an interest in real property located in the United States or the Virgin Islands, USRPIs include (among other things) any interest in a domestic corporation unless the taxpayer establishes that the corporation was not, during a five-year period ending on the date of the disposition of the interest, a U.S. real property holding corporation (which

[514] Secs. 871(h)(2), (5) and 881(c)(2).
[515] Sec. 881(c)(3).
[516] Secs. 871(h)(4) and 881(c)(4).
[517] This interest distribution rule was added by section 411 of the American Jobs Creation Act of 2004 ("AJCA"), Pub. L. No. 108–357.
[518] Secs. 871(a)(2) and 881.
[519] Treas. Reg. sec. 1.1441–3(c)(2)(D).
[520] This short-term gain distribution rule was added by section 411 of AJCA.
[521] Sec. 897.

is defined generally to mean any corporation the fair market value of whose U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of its real property interests and any other of its assets used or held for use in a trade or business).

Distributions by a REIT to its foreign shareholders attributable to the sale of USRPI's are generally treated as income from the sale of USRPIs.[522] Treasury regulations require the REIT to withhold at 35 percent on such a distribution.[523] However, there is an exception for distributions by a REIT with respect to stock of the REIT that is regularly traded on an established securities market located in the U.S., to a foreign shareholder that has not held more than 5 percent of the stock of the REIT for the one year period ending with the date of the distribution.[524] In such cases, the REIT and the shareholder treat the distribution to a foreign shareholder as the distribution of an ordinary dividend,[525] subject to the 30-percent (or lower treaty rate) withholding applicable to dividends.

For 2005, 2006, and 2007, any RIC distribution to a foreign shareholder attributable to the sale of USRPIs is treated as FIRPTA income, without any exceptions.[526] However, no Treasury regulations have been issued addressing withholding obligations with respect to such distributions.

A more complete description of the provisions of FIRPTA and the special rules under FIRPTA that apply to RICs and REITs is contained under "Present Law" for the provision "Application of Foreign Investors in Real Property Tax Act (FIRPTA) to Regulated Investment Companies (RICS).

Although the law thus provides rules for taxing foreign persons under FIRPTA on distributions of gain from the sale of USRPIs by RICs or REITs, some taxpayers may be taking the position that if a foreign person invests in a RIC or REIT that, in turn, invests in a lower-tier RIC or REIT that is the entity that disposes of USRPIs and distributes the proceeds, then the proceeds from such disposition by the lower-tier RIC or REIT cease to be FIRPTA income when distributed to the upper-tier RIC or REIT (which is not itself a foreign person), and can thereafter be distributed by that latter entity to its foreign shareholders as non- FIRPTA income of such RIC or REIT, rather than continuing to be categorized as FIRPTA income. Furthermore, RICs may take the position that in the absence of regulations or a specific statutory rule addressing the withholding rules for FIRPTA capital gain that is treated as effectively connected with a U.S. trade or business, such gain should be considered capital gain for which no withholding is required.

In addition, some foreign persons may be attempting to avoid FIRPTA tax on a distribution from a RIC or a REIT, by selling the RIC or REIT stock shortly before the distribution and buying back the stock shortly after the distribution. If the stock is not a U.S. real property interest in the hands of the foreign seller, that person

[522] Sec. 897(h)(1).
[523] Treas. Reg. sec. 1.1445–8.
[524] Sec. 897(h)(1)(second sentence).
[525] Sec. 857(b)(3)(F).
[526] Sec. 897(h)(1)

would take the position that the gain on the sale of the stock is capital gain not subject to U.S. tax. Stock of a RIC or REIT that is "domestically controlled" is not a U.S. real property interest.[527]

If the stock is a USRPI in the hands of the foreign person, the transferee generally is required to withhold 10 percent of the gross sales price under general FIRPTA withholding rules.[528]

HOUSE BILL

No provision.

SENATE AMENDMENT

The first part of the Senate amendment provision requires any distribution that is made by a RIC or a REIT that would otherwise be subject to FIRPTA because the distribution is attributable to the disposition of a U.S. real property interest (USRPI) to retain its character as FIRPTA income when distributed to any other RIC or REIT, and to be treated as if it were from the disposition of a USRPI by that other RIC or REIT. Under the provision, a RIC continues to be subject to FIRPTA, even after December 31, 2007, in any case in which a REIT makes a distribution to the RIC that is attributable to gain from the sale of U.S. real property interests.

The second part of the Senate amendment provision provides that a distribution by a RIC to a foreign shareholder, or to a RIC or REIT shareholder, attributable to sales of USRPIs is not treated as gain from the sale of a USRPI by that shareholder if the distribution is made with respect to a class of RIC stock that is regularly traded on an established securities market[529] located in the U.S. and if such shareholder did not hold more than 5 percent of such stock within the one year period ending on the date of the distribution. Such distributions instead are treated as dividend distributions.[530]

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[527] Sec. 897(g)(3). A RIC or REIT is "domestically controlled" if less than 50 percent in value of the entity's stock is held by foreign persons. RIC stock ceases to be eligible for this exception as of the end of 2007. Distributions by a domestically controlled RIC or REIT, if attributable to the sale of U.S. real property interests, are not exempt from FIRPTA by reason of such domestic control. A foreign person that would be subject to FIRPTA on receipt of a distribution from such an entity might sell its stock before the distribution and repurchase stock after the distribution in an attempt to avoid FIRPTA consequences.

Under a different exception from FIRPTA, applicable to stock of all entities, neither RIC nor REIT stock is a U.S. real property interest if the RIC or REIT stock is regularly traded on an established securities market located in the United States and if the stock sale is made by a foreign shareholder that has not owned more than five percent of the stock during the five years ending with the date of the sale. Sec. 897(c)(3). Distributions by a REIT to a foreign person, attributable to the sale of U.S. real property interests, are also not subject to FIRPTA if made with respect to stock that is regularly traded on an established securities market located in the United States and made to a foreign person that has not held more than five percent of the REIT stock for the one-year period ending on the date of distribution. (Sec. 897(h)(1), second sentence.) Thus, any foreign shareholder of such a regularly traded REIT that would be exempt from FIRPTA on a sale of the REIT stock immediately before a distribution would also generally be exempt from FIRPTA on a distribution from the REIT if such shareholder held the stock through the date of the distribution, due to the holding period requirements. Distributions that are not subject to FIRPTA under this five percent exception are recharacterized as ordinary dividends and thus would normally be subject to ordinary dividend withholding rules. Secs. 857(b)(3)(F) and 1441.

[528] Secs. 1445(a) and 1445(e).

[529] It is intended that the rules generally applicable for this purpose under section 897 also apply under the provision in determining whether a class of interests is regularly traded on an established securities market located in the United States. For example, at the present time the rules currently in force for this purpose include Temp. Reg. sec. 1.897–9T(d)(2).

[530] The provision treats such distributions as ordinary dividend distributions rather than as distributions of long term capital gain. This rule is the same as the present law rule for publicly traded REITs making a distribution to a foreign shareholder. In addition, under the imme-

The third part of the Senate amendment provision requires a foreign person that disposes of stock of a RIC or REIT during the 30-day period preceding a distribution on that stock that would have been treated as a distribution from the disposition of a USRPI, that acquires an identical stock interest during the 60 day period beginning the first day of such 30-day period preceding the distribution, and that does not in fact receive the distribution in a manner that subjects the person to tax under FIRPTA, to pay FIRPTA tax on an amount equal to the amount of the distribution that was not taxed under FIRPTA as a result of the disposition. A foreign person is treated as having acquired any interest acquired by any person treated as related to that foreign first person under section 465(b)(3)(C).[531]

This third part of the Senate amendment provision applies only in the case of a shareholder that would have been treated as receiving FIRPTA income on the distribution if that shareholder had in fact received the distribution, but that would not have been treated as receiving FIRPTA income if the form of the disposition transaction were respected. This category of persons consists of persons that are shareholders in a domestically controlled RIC or REIT (since sales of shares of such an entity are not subject to FIRPTA tax), but does not include a person who sells stock that is regularly traded on an established securities market located in the U.S. and who did not own more than five percent of such stock during the one year period ending on the date of the distribution (since such a person would not have been subject to FIRPTA tax under present law for REITs and under the second part of the Senate amendment provision for RICs, supra., if that person had received the dividend instead of disposing of the stock).

Notwithstanding the recharacterization of the disposition as involving a FIRPTA distribution to the foreign person, no withholding on disposition proceeds to the foreign person on the disposition of such stock would be required. No inference is intended as to what situations under present law would or would not be respected as dispositions.

Effective dates.—The first part of the Senate amendment provision is effective for distributions with respect to taxable years of a RIC or REIT beginning after the date of enactment.

The second part of the Senate amendment provision applies to dividends with respect to taxable years of regulated investment companies beginning after December 31, 2004.

The third part of the Senate amendment provision is effective for dispositions after December 31, 2005, in taxable years ending after that date.

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diately preceding provision (sec. 464) of the Senate amendment, for the years 2005, 2006 and 2007 that RICs are subject to FIRPTA, a RIC can make distributions from sales of USRPIs to shareholders who do not meet this rule, and such distributions will be treated not as dividends but as non-taxable long- or short-term capital gain, if so designated by the RIC, as long as the RIC itself is not a USRPHC after applying the special rules for counting the RIC's ownership of REIT or other RIC stock.

[531] These relationships generally include persons that are engaged in trades or businesses under common control (generally, a more than 50 percent relationship) and also include persons that have a more than 10 percent relationship, such as (for example) a corporation and an individual owning more than 10 percent of the corporation; or a corporation and a partnership if the same persons own more than 10 percent of the interests in each.

CONFERENCE AGREEMENT

The conference agreement includes the Senate amendment provision with modifications and clarifications.

The conference agreement provides that the second part of the Senate amendment provision, treating certain distributions attributable to sales of U.S. real property interests as dividends subject to dividend withholding, applies when the distribution is made to a foreign shareholder of a RIC or REIT, but does not apply when the distribution is made to another RIC or a REIT. In such cases, the character of the distribution as FIRPTA gain is retained and must be tracked by the recipient RIC or REIT, but the distribution itself does not become dividend income in the hands of such RIC or REIT. Therefore, such recipient RIC or REIT can in turn distribute amounts attributable to that distribution (attributable to the sale of USRPIs) to its U.S shareholders as capital gain. However, if any recipient RIC or REIT in turn distributes to a foreign shareholder amounts that are attributable to a sale by a lower tier RIC or REIT of USRPIs, such amounts distributed to a foreign shareholder shall be treated as FIRPTA gain or as dividend income, according to whether or not such distribution to such foreign shareholder qualifies for dividend treatment.

The conference agreement amends section 1445 so that it explicitly requires withholding on RIC and REIT distributions to foreign persons, attributable to the sale of USRPIs, at 35 percent, or, to the extent provided by regulations, at 15 percent.[532]

The conference agreement clarifies that the treatment of a RIC as a qualified investment entity continues after December 2007 with respect to a RIC that receives a distribution from a REIT, not only for purposes of the distribution rules, including withholding on distributions to foreign shareholders, but also for purposes of the new "wash sale" rules of the provision.

The conference agreement modifies the new "wash sale" rule. The period within which the basic "wash-sale" rule applies is changed from 60 days to 61 days.[533] The definition of "applicable wash sales transaction" is expanded to cover not only situations in which the taxpayer acquires a substantially identical interest, but also situations in which the taxpayer enters into a contract or option to acquire such an interest. The related party rule is also modified to apply the 50-percent relationship test under section 267(b) and 707(b)(1) rather than a 10-percent test.

In addition, treatment of a foreign shareholder of a RIC or REIT as if it had received a FIRPTA distribution that is treated as U.S. effectively connected income is extended to transactions that meet the definition of "substitute dividend payments" provided for purposes of section 861 and that would be properly treated by

[532] This provision is similar to present law section 1445(c)(1). The regulatory authority to reduce the withholding to 15 percent sunsets in accordance with the same sunset that applies to section 1445(c)(1), at the time that the present law maximum 15 percent rate on dividends is scheduled to sunset.

Treasury regulations under section 1445 already impose FIRPTA withholding on REITs under present law. Treasury has not yet written regulations applicable to RICs. No inference is intended regarding the existing Treasury regulations in force under section 1445 with respect to REITs.

[533] Thus the period includes the 30 days before and the 30 days after the ex-dividend date, in addition to the ex-dividend date itself.

the foreign taxpayer as receipt of a distribution of FIRPTA gain if the distribution from the RIC or REIT had itself been received by the taxpayer, but that, by virtue of the substitute dividend payment, is not so treated but for the provision,[534] as well as to other similar arrangements to which Treasury may extend the rules.

Effective date.—The first part of the conference agreement provision, relating to distributions generally, applies to distributions with respect to taxable years of RICs and REITs beginning after December 31, 2005, except that no withholding is required under sections 1441, 1442, or 1445 with respect to any distribution before the date of enactment if such amount was not otherwise required to be withheld under any such section as in affect before the amendments made by the conference agreement.

The second part of the conference agreement, relating to the "wash sale" and substitute dividend payment transactions, is applicable to distributions and substitute dividend payments occurring on or after the 30th day following the date of enactment.

No inference is intended regarding the treatment under present law of any transactions addressed by the conference agreement.

16. Credit to holders of rural renaissance bonds (sec. 469 of the Senate amendment)

PRESENT LAW

In general

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

Private activity bonds are eligible for tax-exemption if issued for certain purposes permitted by the Code ("qualified private activity bonds"). Generally, qualified private activity bonds are subject to restrictions on the use of proceeds for the acquisition of land and

[534] The conference agreement adopts the definition of "substitute dividend payment" used for purposes of section 861, which definition applies to determine substitute dividend payments under the conference agreement provision, even though the recipient may not be an individual and even though the underlying payment would not have been treated as a dividend to the recipient but as a distribution of FIRPTA gain. Treasury regulations section 1.861–3(a)(6) defines a "substitute dividend payment" as a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction. The regulation applies to amounts received or accrued by the taxpayer. The regulation defines a securities lending transaction as a transfer of one or more securities that is described in section 1058(a) or a substantially similar transaction. The regulation defines a sale-repurchase transaction as an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive substantially identical securities from the transferee in the future in exchange for cash. Under the regulation, a "substitute dividend payment" is generally sourced and in many instances characterized in the same manner as the underlying distribution with respect to the transferred security.

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

Tax-credit bonds

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

Arbitrage restrictions on tax-exempt bonds

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

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment creates a new category of tax-credit bonds to finance certain projects located in rural areas ("Rural Ren-

aissance Bonds"). As with present law tax-credit bonds, the taxpayer holding Rural Renaissance Bonds on the allowance date would be entitled to a tax credit. The amount of the credit would be determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit would be includible in gross income (as if it were an interest payment on the bond) and could be claimed against regular income tax liability and alternative minimum tax liability.

Under the Senate amendment, Rural Renaissance Bonds are defined as any bonds 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 for one or more qualified projects. "Qualified projects" include any of the following projects located in a rural area: (i) a water or waste treatment project, (ii) an affordable housing project, (iii) a community facility project, including hospitals, fire and police stations, and nursing and assisted-living facilities, (iv) a value-added agriculture or renewable energy facility project for agricultural producers or farmer-owned entities, including any project to promote the production, processing, or retail sale of ethanol (including fuel at least 85 percent of the volume of which consists of ethanol), bio-diesel, animal waste, biomass, raw commodities, or wind as a fuel, (v) a distance learning or telemedicine project, (vi) a rural utility infrastructure project, including any electric or telephone system, (vii) a project to expand broadband technology, (viii) a rural teleworks project, and (ix) any of the previously described projects if carried out by the Delta Regional Authority. A "rural area" means any area other than a city or town which has a population of greater than 50,000 inhabitants or the urbanized area contiguous and adjacent to such a city or town.

For purposes of the provision, the term "qualified issuer" means any not-for-profit cooperative lender which, as of the date of enactment of this provision, has received a guarantee under the Rural Electrification Act. A qualified issuer must also meet a user fee requirement during the period any Rural Renaissance Bond issued by such qualified issuer is outstanding. The user fee requirement is met if the qualified issuer makes semi-annual grants for qualified projects equal to the outstanding principal of Rural Renaissance Bond issued by such issuer multiplied by one-half the rate on United States Treasury securities of the same maturity.

The Senate amendment imposes a maximum maturity limitation on Rural Renaissance Bonds. The maximum maturity is the term which the Secretary estimates will result in the present value of the obligation to repay the principal on any bonds being equal to 50 percent of the face amount of such bond. The provision also requires level amortization of Rural Renaissance Bonds during the period such bonds are outstanding.

To qualify as Rural Renaissance Bonds, the qualified issuer of such bonds 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 Rural Renaissance Bonds if unspent proceeds

are used within 90 days from the end of such five-year period to redeem any "nonqualified bonds." For these purposes, the amount of nonqualified bonds is to be determined in the same manner as Treasury regulations under section 142. In addition, the provision provides that the five-year spending period may be extended by the Secretary upon the qualified issuer's request.

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

Rural Renaissance Bonds must be designated as such by the qualified issuer and must be issued in registered form. The provision also requires issuers of Rural Renaissance Bonds to report issuance to the IRS in a manner similar to that required for tax-exempt bonds. There is a national limitation of $200 million of Rural Renaissance Bonds that the Secretary may allocate, in the aggregate, to qualified projects. The authority to issue Rural Renaissance Bonds expires December 31, 2009.

Effective date.—The provision is effective for bonds issued after the date of enactment and before January 1, 2010.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

17. Modify foreign tax credit rules for large integrated oil companies which are dual capacity taxpayers (sec. 470 of the Senate amendment and sec. 901 of the Code)

PRESENT LAW

U.S. persons are subject to U.S. income tax on their worldwide income. A credit against U.S. tax on foreign source income is allowed for foreign taxes that are paid or accrued.[535] In addition, a domestic corporation which owns 10 percent or more of the voting stock of a foreign corporation from which it receives dividends or with respect to which it is taxed under the rules of subpart F is deemed to have paid a portion of the foreign taxes of such foreign corporation.[536] The foreign tax credit is available only for foreign income, war profits, and excess profits taxes, and for certain taxes that qualify under section 903 as imposed "in lieu" of such taxes.

[535] Sec. 901. Foreign taxes include taxes imposed by possessions.

[536] Secs. 902 and 960. Foreign corporations include corporations created or organized in possessions.

Other foreign levies generally are treated as deductible expenses only.

The amount of foreign tax credits that a taxpayer may claim in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. The foreign tax credit limitation is calculated separately for specific categories of income. The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back one year and carried forward 10 years.

Treasury regulations provide detailed rules for determining whether a foreign levy is a creditable income tax. A levy generally is a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and is not compensation for a specific economic benefit provided by a foreign country. A taxpayer that is subject to a foreign levy and also receives a specific economic benefit from such country is considered a "dual capacity taxpayer."[537] Treasury regulations provide that the portion of a foreign levy paid by a dual capacity taxpayer that is considered a tax is determined based on all the facts and circumstances.[538] Alternatively, under a safe harbor provided in the regulations, the portion of a foreign levy paid by a dual capacity taxpayer that is creditable is determined based on the foreign country's generally imposed income tax or, if the foreign country has no generally imposed income tax, the U.S. tax.[539]

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment denies the foreign tax credit with respect to all amounts paid or accrued (or deemed paid) to any foreign country or possession by a large integrated oil company which is a dual capacity taxpayer if the country or possession does not impose a generally applicable income tax. The provision modifies the safe harbor rule currently provided by Treasury Regulations. Under the provision, as under present law, a dual capacity taxpayer is a person who is subject to a levy in a foreign country or possession and also directly or indirectly receives (or will receive) a specific economic benefit (as determined in accordance with regulations) from such foreign country or possession. A generally applicable income tax is an income tax that is generally imposed on income derived from a trade or business conducted within that foreign country or possession (which may include taxes qualifying under section 903 as imposed in lieu of income taxes), provided that the tax has substantial application (by its terms and in practice) to persons who are not dual capacity taxpayers and to persons who are citizens or residents of the foreign country or possession.

If the country does impose a generally applicable income tax, the foreign tax credit is denied to the extent that such amounts ex-

[537] Treas. Reg. sec. 1.901–2(a)(2)(ii)(A).
[538] Treas. Reg. sec. 1.901–2A(c)(2)(i).
[539] Treas. Reg. sec. 1.901–2A(e).

ceed the amount (as determined under regulations) which is paid by the dual capacity taxpayer pursuant to such generally applicable income tax, or which would have been paid if such generally applicable income tax were applicable to the dual capacity taxpayer. Amounts not in excess of the amount calculated under the generally applicable income tax are subject to all other rules pertaining to foreign tax credits. Amounts for which the foreign tax credit is denied under the provision are not subject to carryback or carryforward, but could constitute deductible expenses if such amounts qualify under the relevant deduction provisions. The provision does not apply to the extent contrary to any treaty obligation of the United States.

The provision applies only to "large integrated oil companies." These are persons that meet all of the following requirements for a particular taxable year: (1) the person is a producer of crude oil; (2) the person has gross receipts in excess of one billion dollars; (3) the person or persons related to such person has an average daily worldwide production of crude oil of at least 500,000 barrels; and (4) either (a) the person or persons related to such person sells at retail oil or natural gas (excluding bulk sales of such items to commercial or industrial users), or any product derived from oil or natural gas (excluding bulk sales of aviation fuels to the Department of Defense), in an aggregate amount of five million dollars or greater, or (b) the person or persons related to such person engage in the refining of crude oil, if the aggregate average daily refinery runs for that taxable year exceeds 75,000 barrels. For purposes of requirement (4), a person is a related person with respect to another person if either one owns a five percent or greater interest in the other, or if a third person owns such an interest in both.

Effective date.—The provision applies to taxes paid or accrued in taxable years beginning after the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

18. Disability preference program for tax collection contracts (sec. 471 of the Senate amendment)

PRESENT LAW

Under present law, the IRS may use private debt collection companies to locate and contact taxpayers owing outstanding tax liabilities of any type and to arrange payment of those taxes by the taxpayers.

There are several procedural conditions applicable to the use of private debt collection contracts. First, provisions of the Fair Debt Collection Practices Act apply to the private debt collection company. Second, taxpayer protections that are statutorily applicable to the IRS are also made statutorily applicable to the private sector debt collection companies. In addition, taxpayer protections that are statutorily applicable to IRS employees also are made statutorily applicable to employees of private sector debt collection companies. Third, subcontractors are prohibited from having contact with taxpayers, providing quality assurance services, and com-

posing debt collection notices; any other service provided by a subcontractor must receive prior approval from the IRS.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment provides that the IRS may not enter a contract with a private debt collection company after April 1, 2006, until the Secretary implements a qualified disability preference program. A qualified disability preference program is a program that requires qualified employers to receive not less than 10 percent of taxpayer accounts (based on dollar value) awarded to private debt collection companies. A qualified employer is an employer who, as of the date the private debt collection contract is awarded, employs not less than 50 severely disabled individuals or not less than 30 percent of such employer's employees are severely disabled. In addition, a qualified employer must agree that not more than 90 days after being awarded a private debt collection contract not less than 35 percent of the employees providing services under the private debt collection contract shall be severely disabled individuals and hired after the date the contract is awarded.

For purposes of the provision, a severely disabled individual means (i) a veteran of the United States armed forces with a disability of 50 percent or greater determined by law or the Secretary of Veterans Affairs to be service-connected or (ii) any individual who is a disabled beneficiary as defined by the Social Security Act or would be considered to such a disabled beneficiary but for having income or resources in excess of limits established by the Social Security Act.

Effective date.—The provision is effective on the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

TITLE VI—SUNSET OF CERTAIN PROVISIONS AND AMENDMENTS

(Sec. 501 of the Senate amendment)

PRESENT LAW

Reconciliation is a procedure under the Congressional Budget Act of 1974 (the "Budget Act") by which Congress implements spending and tax policies contained in a budget resolution. The Budget Act contains numerous rules enforcing the scope of items permitted to be considered under the budget reconciliation process. One such rule, the so-called "Byrd rule," was incorporated into the Budget Act in 1990. The Byrd rule, named after its principal sponsor, Senator Robert C. Byrd, is contained in section 313 of the Budget Act. The Byrd rule generally permits members to raise a point of order against extraneous provisions (those which are unre-

lated to the goals of the reconciliation process) from either a reconciliation bill or a conference report on such bill.

Under the Byrd rule, a provision is considered to be extraneous if it falls under one or more of the following six definitions:

1. It does not produce a change in outlays or revenues;

2. It produces an outlay increase or revenue decrease when the instructed committee is not in compliance with its instructions;

3. It is outside of the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure;

4. It produces a change in outlays or revenues which is merely incidental to the nonbudgetary components of the provision;

5. It would increase the deficit for a fiscal year beyond those covered by the reconciliation measure; and

6. It recommends changes in Social Security.

HOUSE BILL

No provision.

SENATE AMENDMENT

To ensure compliance with the Budget Act, the Senate amendment provides that the provisions of, and amendments made by, title I, subtitle A of title II, and title III of the Senate amendment shall not apply to taxable years beginning after September 30, 2010, and that the Code shall be applied and administered to such years as if those provisions and amendments had never been enacted.

Effective date.—The provision is effective on the date of enactment.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

TITLE VII—FUNDING FOR MILITARY OPERATIONS

(Secs. 601 and 602 of the Senate amendment)

PRESENT LAW

Present law does not include the Senate amendment provision.

HOUSE BILL

No provision.

SENATE AMENDMENT

The Senate amendment provides that there is to be appropriated, out of any money in the Treasury that is not otherwise appropriated, for the fiscal years 2006 through 2010, the following amounts, to be used for resetting and recapitalizing equipment being used in theaters of operations: (1) $16,900,000,000 for operations and maintenance of the Army; (2) $1,800,000,000 for aircraft for the Army; (3) $6,300,000,000 for other Army procurement; (4) $10,000,000,000 for wheeled and tracked combat vehicles for the

Army; (5) $467,000,000 for the Army working capital fund; (6) $6,000,000 for missiles for the Department of Defense; (7) $100,000,000 for defense wide procurement for the Department of Defense; (8) $4,500,000,000 for Marine Corps procurement; (9) $4,500,000,000 for operations and maintenance of the Marine Corps; and (10) $2,700,000,000 for Navy aircraft procurement.

CONFERENCE AGREEMENT

The conference agreement does not include the Senate amendment provision.

TITLE VIII—OTHER REVENUE OFFSET PROVISIONS

A. Imposition of Withholding on Certain Payments Made by Government Entities

(Sec. 3402 of the Code)

PRESENT LAW

Withholding requirements

Employers are required to withhold income tax on wages paid to employees, including wages and salaries of employees or elected officials of Federal, State, and local government units. Withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee.

Certain non-wage payments also are subject to mandatory or voluntary withholding. For example:

- Employers are required to withhold FICA and Railroad Retirement taxes from wages paid to their employees. Withholding rates are generally uniform.
- Payors of pensions are required to withhold from payments made to payees, unless the payee elects no withholding.[540] Withholding from periodic payments is at variable rates, parallel to income tax withholding from wages, whereas withholding from nonperiodic payments is at a flat 10-percent rate.
- A variety of payments (such as interest and dividends) are subject to backup withholding if the payee has not provided a valid taxpayer identification number (TIN). Withholding is at a flat rate based on the fourth lowest rate of tax applicable to single taxpayers.
- Certain gambling proceeds are subject to withholding. Withholding is at a flat rate based on the third lowest rate of tax applicable to single taxpayers.
- Voluntary withholding applies to certain Federal payments, such as Social Security payments. Withholding is at rates specified by Treasury regulations.
- Voluntary withholding applies to unemployment compensation benefits. Withholding is at a flat 10-percent rate.
- Foreign taxpayers are generally subject to withholding on certain U.S.-source income which is not effectively connected with

[540] Withholding at a rate of 20 percent is required in the case of an eligible rollover distribution that is not directly rolled over.

the conduct of a U.S. trade or business. Withholding is at a flat 30-percent rate (14-percent for certain items of income).

Many payments, including payments made by government entities, are not subject to withholding under present law. For example, no tax is generally withheld from payments made to workers who are not classified as employees (i.e., independent contractors).

Information reporting

Present law imposes numerous information reporting requirements that enable the Internal Revenue Service ("IRS") to verify the correctness of taxpayers' returns. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of $600 or more made in the course of the payor's trade or business. Special information reporting requirements exist for employers required to deduct and withhold tax from employees' income. In addition, any service recipient engaged in a trade or business and paying for services is required to make a return according to regulations when the aggregate of payments is $600 or more. Government entities are specifically required to make an information return, reporting certain payments to corporations as well as individuals. Moreover, the head of every Federal executive agency that enters into certain contracts must file an information return reporting the contractor's name, address, TIN, date of contract action, amount to be paid to the contractor, and any other information required by Forms 8596 (Information Return for Federal Contracts) and 8596A (Quarterly Transmittal of Information Returns for Federal Contracts).

HOUSE BILL

No provision.

SENATE AMENDMENT

No provision.

CONFERENCE AGREEMENT

The conference agreement requires withholding on certain payments to persons providing property or services made by the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies). The withholding requirement applies regardless of whether the government entity making such payment is the recipient of the property or services. Political subdivisions of States (or any instrumentality thereof) with less than $100 million of annual expenditures for property or services that would otherwise be subject to withholding under this provision are exempt from the withholding requirement.

The rate of withholding is three percent on all payments regardless of whether the payments are for property or services. Payments subject to withholding under the provision include any payment made in connection with a government voucher or certificate program which functions as a payment for property or services. For example, payments to a commodity producer under a government commodity support program are subject to the withholding require-

ment. The provision imposes information reporting requirements on the payments that are subject to withholding under the provision.

The provision does not apply to any payments made through a Federal, State, or local government public assistance or public welfare program for which eligibility is determined by a needs or income test. For example, payments under government programs providing food vouchers or medical assistance to low-income individuals are not subject to withholding under the provision. However, payments under government programs to provide health care or other services that are not based on the needs or income of the recipients are subject to withholding, including programs where eligibility is based on the age of the beneficiary.

The provision does not apply to payments of wages or to any other payment with respect to which mandatory (e.g., U.S.-source income of foreign taxpayers) or voluntary (e.g., unemployment benefits) withholding applies under present law. The provision does not exclude payments that are potentially subject to backup withholding under section 3406. If, however, payments are actually being withheld under backup withholding, withholding under the provision does not apply.

The provision also does not apply to the following: payments of interest; payments for real property; payments to tax-exempt entities or foreign governments; intra-governmental payments; payments made pursuant to a classified or confidential contract (as defined in section 6050M(e)(3)); and payments to government employees that are not otherwise excludable from the new withholding provision with respect to the employees' services as an employees.

Effective date.—The provision applies to payments made after December 31, 2010.

B. Eliminate Income Limitations on Roth IRA Conversions

(Sec. 408A of the Code)

PRESENT LAW

There are two general types of individual retirement arrangements ("IRAs"): traditional IRAs and Roth IRAs. The total amount that an individual may contribute to one or more IRAs for a year is generally limited to the lesser of: (1) a dollar amount ($4,000 for 2006); and (2) the amount of the individual's compensation that is includible in gross income for the year. In the case of an individual who has attained age 50 before the end of the year, the dollar amount is increased by an additional amount ($1,000 for 2006). In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses that is includible in gross income is at least equal to the contributed amount. IRA contributions in excess of the applicable limit are generally subject to an excise tax of six percent per year until withdrawn.

Contributions to a traditional IRA may or may not be deductible. The extent to which contributions to a traditional IRA are deductible depends on whether or not the individual (or the individual's spouse) is an active participant in an employer-sponsored re-

tirement plan and the taxpayer's AGI. An individual may deduct his or her contributions to a traditional IRA if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual or the individual's spouse is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with AGI over certain levels. To the extent an individual does not or cannot make deductible contributions, the individual may make nondeductible contributions to a traditional IRA, subject to the maximum contribution limit. Distributions from a traditional IRA are includible in gross income to the extent not attributable to a return of nondeductible contributions.

Individuals with adjusted gross income ("AGI") below certain levels may make contributions to a Roth IRA (up to the maximum IRA contribution limit). The maximum Roth IRA contribution is phased out between $150,000 to $160,000 of AGI in the case of married taxpayers filing a joint return and between $95,000 to $105,000 in the case of all other returns (except a separate return of a married individual).[541] Contributions to a Roth IRA are not deductible. Qualified distributions from a Roth IRA are excludable from gross income. Distributions from a Roth IRA that are not qualified distributions are includible in gross income to the extent attributable to earnings. In general, a qualified distribution is a distribution that is made on or after the individual attains age 59½, death, or disability or which is a qualified special purpose distribution. A distribution is not a qualified distribution if it is made within the five-taxable year period beginning with the taxable year for which an individual first made a contribution to a Roth IRA.

A taxpayer with AGI of $100,000 or less may convert all or a portion of a traditional IRA to a Roth IRA.[542] The amount converted is treated as a distribution from the traditional IRA for income tax purposes, except that the 10-percent additional tax on early withdrawals does not apply.

In the case of a distribution from a Roth IRA that is not a qualified distribution, certain ordering rules apply in determining the amount of the distribution that is includible in income. For this purpose, a distribution that is not a qualified distribution is treated as made in the following order: (1) regular Roth IRA contributions; (2) conversion contributions (on a first in, first out basis); and (3) earnings. To the extent a distribution is treated as made from a conversion contribution, it is treated as made first from the portion, if any, of the conversion contribution that was required to be included in income as a result of the conversion.

Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59½, death, or disability are subject to an additional 10-percent early withdrawal tax, unless an exception applies.

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[541] In the case of a married taxpayer filing a separate return, the phaseout range is $0 to $10,000 of AGI.

[542] Married taxpayers filing a separate return may not convert amounts in a traditional IRA into a Roth IRA.

HOUSE BILL

No provision.

SENATE AMENDMENT

No provision.

CONFERENCE AGREEMENT

The conference agreement eliminates the income limits on conversions of traditional IRAs to Roth IRAs.[543] Thus, taxpayers may make such conversions without regard to their AGI.

For conversions occurring in 2010, unless a taxpayer elects otherwise, the amount includible in gross income as a result of the conversion is included ratably in 2011 and 2012. That is, unless a taxpayer elects otherwise, none of the amount includible in gross income as a result of a conversion occurring in 2010 is included in income in 2010, and half of the income resulting from the conversion is includible in gross income in 2011 and half in 2012. However, income inclusion is accelerated if converted amounts are distributed before 2012.[544] In that case, the amount included in income in the year of the distribution is increased by the amount distributed, and the amount included in income in 2012 (or 2011 and 2012 in the case of a distribution in 2010) is the lesser of: (1) half of the amount includible in income as a result of the conversion; and (2) the remaining portion of such amount not already included in income. The following example illustrates the application of the accelerated inclusion rule.

Example.—Taxpayer A has a traditional IRA with a value of $100, consisting of deductible contributions and earnings. A does not have a Roth IRA. A converts the traditional IRA to a Roth IRA in 2010, and, as a result of the conversion, $100 is includible in gross income. Unless A elects otherwise, $50 of the income resulting from the conversion is included in income in 2011 and $50 in 2012. Later in 2010, A takes a $20 distribution, which is not a qualified distribution and all of which, under the ordering rules, is attributable to amounts includible in gross income as a result of the conversion. Under the accelerated inclusion rule, $20 is included in income in 2010. The amount included in income in 2011 is the lesser of (1) $50 (half of the income resulting from the conversion) or (2) $70 (the remaining income from the conversion), or $50. The amount included in income in 2012 is the lesser of (1) $50 (half of the income resulting from the conversion) or (2) $30 (the remaining income from the conversion, i.e., $100—$70 ($20 included in income in 2010 and $50 included in income in 2011)), or $30.

Effective date.—The provision is effective for taxable years beginning after December 31, 2009.

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[543] Under the conference agreement, married taxpayers filing a separate return may convert amounts in a traditional IRA into a Roth IRA.

[544] Whether a distribution consists of converted amounts is determined under the present-law ordering rules.

C. Repeal of FSC/ETI Binding Contract Relief

PRIOR AND PRESENT LAW

For most of the last two decades, the United States provided export-related tax benefits under the foreign sales corporation ("FSC") regime. In 2000, the World Trade Organization ("WTO") held that the FSC regime constituted a prohibited export subsidy under the relevant trade agreements. In response to this WTO finding, the United States repealed the FSC rules and enacted a new regime, under the FSC Repeal and Extraterritorial Income ("ETI") Exclusion Act of 2000. Transition rules delayed the repeal of the FSC rules and the effective date of ETI for transactions in the ordinary course of a trade or business occurring before January 1, 2002, or after December 31, 2001 pursuant to a binding contract between the taxpayer and an unrelated person which was in effect on September 30, 2000 and at all times thereafter (the "FSC binding contract relief").[545] In 2002, the WTO held that the ETI regime also constituted a prohibited export subsidy.

In general, under the ETI regime, an exclusion from gross income applied with respect to "extraterritorial income," which was a taxpayer's gross income attributable to "foreign trading gross receipts." This income was eligible for the exclusion to the extent that it was "qualifying foreign trade income." Qualifying foreign trade income was the amount of gross income that, if excluded, would result in a reduction of taxable income by the greatest of: (1) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transaction; (2) 15 percent of the "foreign trade income" derived by the taxpayer from the transaction;[546] or (3) 30 percent of the "foreign sale and leasing income" derived by the taxpayer from the transaction.[547]

Foreign trading gross receipts were gross receipts derived from certain activities in connection with "qualifying foreign trade property" with respect to which certain economic processes had taken place outside of the United States. Specifically, the gross receipts must have been: (1) from the sale, exchange, or other disposition of qualifying foreign trade property; (2) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States; (3) for services which were related and subsidiary to the sale, exchange, disposition, lease, or rental of qualifying foreign trade property (as described above); (4) for engineering or architectural services for construction projects located outside the United States; or (5) for the performance of certain managerial services for unrelated persons. A taxpayer could elect to treat gross receipts from a transaction as not being foreign trading gross re-

[545] An election was provided, however, under which taxpayers could adopt ETI at an earlier date for transactions after September 30, 2000. This election allowed the ETI rules to apply to transactions after September 30, 2000, including transactions occurring pursuant to pre-existing binding contracts.

[546] "Foreign trade income" was the taxable income of the taxpayer (determined without regard to the exclusion of qualifying foreign trade income) attributable to foreign trading gross receipts.

[547] "Foreign sale and leasing income" was the amount of the taxpayer's foreign trade income (with respect to a transaction) that was properly allocable to activities constituting foreign economic processes. Foreign sale and leasing income also included foreign trade income derived by the taxpayer in connection with the lease or rental of qualifying foreign trade property for use by the lessee outside the United States.

ceipts. As a result of such an election, a taxpayer could use any related foreign tax credits in lieu of the exclusion.

Qualifying foreign trade property generally was property manufactured, produced, grown, or extracted within or outside the United States that was held primarily for sale, lease, or rental in the ordinary course of a trade or business for direct use, consumption, or disposition outside the United States. No more than 50 percent of the fair market value of such property could be attributable to the sum of: (1) the fair market value of articles manufactured outside the United States; and (2) the direct costs of labor performed outside the United States. With respect to property that was manufactured outside the United States, certain rules were provided to ensure consistent U.S. tax treatment with respect to manufacturers.

The American Jobs Creation Act of 2004 ("AJCA") repealed the ETI exclusion,[548] generally effective for transactions after December 31, 2004. AJCA provides a general transition rule under which taxpayers retain 100 percent of their ETI benefits for transactions prior to 2005, 80 percent of their otherwise-applicable ETI benefits for transactions during 2005, and 60 percent of their otherwise-applicable ETI benefits for transactions during 2006.

In addition to the general transition rule, AJCA provides that the ETI exclusion provisions remain in effect for transactions in the ordinary course of a trade or business if such transactions are pursuant to a binding contract[549] between the taxpayer and an unrelated person and such contract is in effect on September 17, 2003, and at all times thereafter (the "ETI binding contract relief").

In early 2006, the WTO Appellate Body held that the ETI general transition rule and the FSC and ETI binding contract relief measures are prohibited export subsidies.

HOUSE BILL

No provision.

SENATE AMENDMENT

No provision.

CONFERENCE AGREEMENT

The conference agreement repeals both the FSC binding contract relief and the ETI binding contract relief. The general transition rule remains in effect.

Effective date.—The provision is effective for taxable years beginning after date of enactment.

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[548] Pub. L. No. 108–357, sec. 101. In addition, foreign corporations that elected to be treated for all Federal tax purposes as domestic corporations in order to facilitate the claiming of ETI benefits were allowed to revoke such elections within one year of the date of enactment of the repeal without recognition of gain or loss, subject to anti-abuse rules.

[549] This rule also applies to a purchase option, renewal option, or replacement option that is included in such contract. For this purpose, a replacement option is considered enforceable against a lessor notwithstanding the fact that a lessor retained approval of the replacement lessee.

D. Modification of Wage Limit for Purposes of Domestic Production Activities Deduction

(Sec. 199 of the Code)

PRESENT LAW

In general

Present law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's qualified production activities income. For taxable years beginning after 2009, the deduction is nine percent of such income. For taxable years beginning in 2005 and 2006, the deduction is three percent of income and, for taxable years beginning in 2007, 2008 and 2009, the deduction is six percent of income. However, the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer during the calendar year that ends in such taxable year.[550]

Qualified production activities income

In general, "qualified production activities income" is equal to domestic production gross receipts (defined by section 199(c)(4)), reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts; and (2) other expenses, losses, or deductions which are properly allocable to such receipts.

Application of wage limitation to passthrough entities

For purposes of applying the wage limitation, a shareholder, partner, or similar person who is allocated components of qualified production activities income from a passthrough entity also is treated as having been allocated wages from such entity in an amount that is equal to the lesser of: (1) such person's allocable share of wages, as determined under regulations prescribed by the Secretary; or (2) twice the qualified production activities income that actually is allocated to such person for the taxable year.

HOUSE BILL

No provision.

SENATE AMENDMENT

No provision.

CONFERENCE AGREEMENT

Under the conference agreement, the wage limitation is modified such that taxpayers may only include amounts which are properly allocable to domestic production gross receipts.[551] Thus, the

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[550] For purposes of the provision, "wages" include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and, for taxable years beginning after December 31, 2005, designated Roth contributions (as defined in section 402A).

[551] As under present law, the Secretary shall provide rules for the proper allocation of items (including wages) in determining qualified production activities income. Section 199(c)(2).

wage limitation is 50 percent of those wages which are deducted in arriving at qualified production activities income.

In addition, the conference agreement repeals the special limitation on wages treated as allocated to partners or shareholders of passthrough entities. Accordingly, for purposes of the wage limitation, a shareholder, partner, or similar person who is allocated components of qualified production activities income from a passthrough entity is treated as having been allocated wages from such entity in an amount that is equal to such person's allocable share of wages as determined under regulations prescribed by the Secretary, even if such amount is more than twice the qualified production activities income that actually is allocated to such person for the taxable year. The shareholder, partner, or similar person will then include in its wage limitation only those wages which are deducted in arriving at qualified production activities income.

Effective date.—The conference agreement is effective with respect to taxable years beginning after the date of enactment.

E. Modification of Exclusion for Citizens Living Abroad

(Sec. 911 of the Code)

PRESENT LAW

In general

U.S. citizens generally are subject to U.S. income tax on all their income, whether derived in the United States or elsewhere. A U.S. citizen who earns income in a foreign country also may be taxed on that income by the foreign country. The United States generally cedes the primary right to tax a U.S. citizen's non-U.S. source income to the foreign country in which the income is derived. This concession is effected by the allowance of a credit against the U.S. income tax imposed on foreign-source income for foreign taxes paid on that income. The amount of the credit for foreign income tax paid on foreign-source income generally is limited to the amount of U.S. tax otherwise owed on that income. Accordingly, if the amount of foreign tax paid on foreign-source income is less than the amount of U.S. tax owed on that income, a foreign tax credit generally is allowed in an amount not exceeding the amount of the foreign tax, and a residual U.S. tax liability remains.

A U.S. citizen or resident living abroad may be eligible to exclude from U.S. taxable income certain foreign earned income and foreign housing costs.[552] This exclusion applies regardless of whether any foreign tax is paid on the foreign earned income or housing costs. To qualify for these exclusions, an individual (a "qualified individual") must have his or her tax home in a foreign country and must be either (1) a U.S. citizen[553] who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year, or (2) a U.S. citizen or

[552] Sec. 911.

[553] Generally, only U.S. citizens may qualify under the bona fide residence test. A U.S. resident alien who is a citizen of a country with which the United States has a tax treaty may, however, qualify for the section 911 exclusions under the bona fide residence test by application of a nondiscrimination provision of the treaty.

resident present in a foreign country or countries for at least 330 full days in any 12-consecutive-month period.

Exclusion for compensation

The foreign earned income exclusion generally is available for a qualified individual's non-U.S. source earned income attributable to personal services performed by that individual during the period of foreign residence or presence described above. The maximum exclusion amount for any calendar year is $80,000 in 2002 through 2007 and is indexed for inflation after 2007.

Exclusion for housing costs

A qualified individual is allowed an exclusion from gross income (or, as described below, a deduction) for certain foreign housing costs paid or incurred by or on behalf of the individual. The amount of this housing cost exclusion is equal to the excess of a taxpayer's "housing expenses" over a base housing amount. The term "housing expenses" means the reasonable expenses paid or incurred during the taxable year for a taxpayer's housing (and, if they live with the taxpayer, for the housing of the taxpayer's spouse and dependents) in a foreign country. The term includes expenses attributable to housing such as utilities and insurance, but it does not include separately deductible interest and taxes. If the taxpayer maintains a second household outside the United States for a spouse or dependents who do not reside with the taxpayer because of dangerous, unhealthful, or otherwise adverse living conditions, the housing expenses of the second household also are eligible for exclusion. The base housing amount above which costs are eligible for exclusion in a taxable year is 16 percent of the annual salary (computed on a daily basis) of a grade GS–14, step 1, U.S. government employee, multiplied by the number of days of foreign residence or presence (as described above) in the taxable year. For 2006 this salary is $77,793; the current base housing amount therefore is $12,447 (assuming the taxpayer is a bona fide resident of or is present in a foreign country every day during the year).

To the extent otherwise excludable housing costs are not paid or reimbursed by a taxpayer's employer, these costs generally are allowed as a deduction in computing adjusted gross income.

Exclusion limitation amounts

The combined foreign earned income exclusion and housing cost exclusion (including the amount of any deductible housing costs) may not exceed the taxpayer's total foreign earned income for the taxable year. The taxpayer's foreign tax credit is reduced by the amount of the credit that is attributable to excluded income.

Tax brackets

A taxpayer with excludable income under section 911 is subject to tax on the taxpayer's other income, after deductions, starting in the lowest tax rate bracket.

HOUSE BILL

No provision.

SENATE AMENDMENT

No provision.

CONFERENCE AGREEMENT

Exclusion for compensation

The conference agreement provision adjusts for inflation the maximum amount of the foreign earned income exclusion in taxable years beginning in calendar years after 2005 (rather than, as under present law, after 2007). The limitation in 2006 therefore is $82,400.[554]

Exclusion for housing costs

Under the conference agreement, the base housing amount used in calculating the foreign housing cost exclusion in a taxable year is 16 percent of the amount (computed on a daily basis) of the foreign earned income exclusion limitation (instead of the present law 16 percent of the grade GS–14, step 1 amount), multiplied by the number of days of foreign residence or presence (as previously described) in that year.

Reasonable foreign housing expenses in excess of the base housing amount remain excluded from gross income (or, if paid by the taxpayer, are deductible) under the conference agreement, but the amount of the exclusion is limited to 30 percent of the maximum amount of a taxpayer's foreign earned income exclusion.[555] The Secretary is given authority to issue regulations or other guidance providing for the adjustment of this 30-percent housing cost limitation based on geographic differences in housing costs relative to housing costs in the United States. The conferees intend that the Secretary be permitted to use publicly available data, such as the Quarterly Report Indexes published by the U.S. Department of State or any other information deemed reliable by the Secretary, in making adjustments. The conferees also intend that the Secretary may adjust the 30-percent amount upward or downward. The conferees intend that the Secretary make adjustments annually.

Under the 30-percent rule described above, the maximum amount of the foreign housing cost exclusion in 2006 is (assuming foreign residence or presence on all days in the year) $11,536 (= ($82,400 × 30 percent) − ($82,400 × 16 percent)).[556]

Tax brackets

Under the conference agreement, if an individual excludes an amount from income under section 911, any income in excess of the exclusion amount determined under section 911 is taxed (under the regular tax and alternative minimum tax) by applying to that in-

[554] This $82,400 amount is calculated under section 911(b)(2)(D)(ii), as amended by the conference agreement provision, using current U.S. Bureau of Labor Statistics ("BLS") Consumer Price Index data.

[555] In certain programs including grant-making to subsidize rents, the U.S. Department of Housing and Urban Development considers maximum affordable housing costs to be 30 percent of a household's income. See, e.g., United States Housing Act of 1937, 42 U.S.C. sec. 1437a (a)(1)(A), as amended.

[556] The $11,536 amount is based on a calculation under section 911(b)(2)(D)(ii), as amended by the conference agreement, using the BLS data described above.

come the tax rates that would have been applicable had the individual not elected the section 911 exclusion. For example, an individual with $80,000 of foreign earned income that is excluded under section 911 and with $20,000 in other taxable income (after deductions) would be subject to tax on that $20,000 at the rate or rates applicable to taxable income in the range of $80,000 to $100,000.

Effective date

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

TITLE IX—CORPORATE ESTIMATED TAX PROVISIONS

PRESENT LAW

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

HOUSE BILL

No provision.

SENATE AMENDMENT

No provision.

CONFERENCE AGREEMENT

In case of a corporation with assets of at least $1 billion, payments due in July, August, and September, 2006, shall be increased to 105 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

In case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2012, shall be increased to 106.25 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

In case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2013, shall be increased to 100.75 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

With respect to corporate estimated tax payments due on September 15, 2010, 20.5 percent shall not be due until October 1, 2010.

With respect to corporate estimated tax payments due on September 15, 2011, 27.5 percent shall not be due until October 1, 2011.

Effective date.—The provision is effective on the date of enactment.

TITLE X—COMPLEXITY ANALYSIS

Section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998 (the "IRS Reform Act") requires the Joint Committee on Taxation (in consultation with the Internal Revenue

Service ("IRS") and the Department of the Treasury) to provide a tax complexity analysis. The complexity analysis is required for all legislation reported by the Senate Committee on Finance, the House Committee on Ways and Means, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Internal Revenue Code (the "Code") and has widespread applicability to individuals or small businesses. For each such provision identified by the staff of the Joint Committee on Taxation, a summary description of the provision is provided along with an estimate of the number and type of affected taxpayers, and a discussion regarding the relevant complexity and administrative issues.

Following the analysis of the staff of the Joint Committee on Taxation are the comments of the IRS and Treasury regarding each of the provisions included in the complexity analysis.

Capital gain and dividend rate reduction (sec. 102 of the conference agreement)

Summary description of provision

The conference agreement extends the zero- and 15-percent capital gain and dividend rates to taxable years beginning in 2009 and 2010.

Number of affected taxpayers

It is estimated that the provision will affect 33 million individual tax returns.

Discussion

The extension of the provision means that for 2009 and 2010 individual taxpayers and the IRS will continue to use the same forms for capital gains and dividends.

The extension of the lower rates for net capital gain will achieve simplification because the extension prevents the separate five-year holding periods from going into effect in 2009 and 2010. On the other hand, the extension of the lower rates for dividends will continue requiring dividends to be classified as qualified dividends and nonqualified dividends in 2009 and 2010 and will continue to require the tax to be computed using the capital gains forms.

Increase in the AMT exemption amount (sec. 301 of the conference agreement)

Summary description of the provision

The alternative minimum tax exemption amounts for 2006 are increased.

Number of affected taxpayers

It is estimated that the provisions will affect approximately 19 million individual tax returns.

Discussion

Many individuals will not have to compute their alternative minimum tax and file the IRS forms relating to that tax.

TITLE XI—UNFUNDED MANDATES

The staff of the Joint Committee on Taxation has reviewed the tax provisions in the conference agreement for H.R. 4297, the "Tax Relief Extension Reconciliation Act of 2005" as agreed to by the conferees. This information is provided in accordance with the requirements of Public Law 104–04, the Unfunded Mandates Reform Act of 1995, which provides that if a conference agreement contains (1) a mandate that was not previously considered by either the House or the Senate, or (2) an increase in the direct cost of a previously considered mandate, then the committee of conference is to ensure, to the greatest extent practicable, that a mandates statement is prepared.

We have determined that the tax provisions of the conference agreement contain two unfunded private sector mandates that were not previously considered by either the House or the Senate: (1) repeal of FSC–ETI grandfather rule, and (2) amend section 911 housing exclusion. In addition, the provision relating to withholding on certain government payments imposes an intergovernmental mandate not previously considered by either the House or the Senate.

The costs required to comply with each Federal private sector mandate and Federal intergovernmental mandate generally are no greater than the aggregate estimated budget effects of the provision as indicated on the enclosed revenue table. Benefits from the provisions include improved administration of the tax laws and a more accurate measurement of income for Federal income tax purposes.

ESTIMATED REVENUE EFFECTS OF THE CONFERENCE AGREEMENT FOR THE "TAX INCREASE PREVENTION AND RECONCILIATION ACT OF 2005"

Fiscal Years 2006 - 2015

[Millions of Dollars]

Provision	Effective	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-10	2006-15
I. Extension and Modification of Certain Provisions													
1. Increase section 179 expensing from $25,000 to $100,000 and increase the phaseout threshold amount from $200,000 to $400,000; include software in section 179 property; and extend indexing of both the deduction limit and the phaseout threshold (sunset 12/31/09)	tyba 12/31/07	---	---	-2,605	-4,459	-209	2,707	1,772	1,222	826	476	-7,274	-271
2. Tax capital gains and dividends with a 15%/0% rate structure:													
a. Capital gains (sunset 12/31/10)	tyba 12/31/08	---	---	-1,549	-8,375	2,672	-54	-12,698	[1]	[1]	---	-7,252	-20,004
b. Dividends (sunset 12/31/10)	tyba 12/31/08	---	---	-860	-4,431	-8,008	-9,368	-6,326	-1,224	-450	-112	-13,299	-30,779
3. Controlled foreign corporations:													
a. Exception under subpart F for active financing income (sunset 12/31/08)	[2]	---	-775	-2,339	-1,682	---	---	---	---	---	---	-4,796	-4,796
b. Look-through treatment of payments between related CFCs under foreign personal holding company income rules (sunset 12/31/08)	[3]	-82	-237	-260	-167	---	---	---	---	---	---	-746	-746
Total of Extension and Modification of Certain Provisions		**-82**	**-1,012**	**-7,613**	**-19,114**	**-5,545**	**-6,715**	**-17,252**	**-2**	**376**	**364**	**-33,367**	**-56,596**
II. Other Provisions													
1. Clarification of taxation of certain settlement funds (sunset 12/31/10)	aafea DOE	-2	-9	-10	-11	-12	-13	-14	-15	-15	-15	-44	-116
2. Modify active business definition under section 355 (sunset 12/31/10)	generally da DOE	-1	-7	-8	-8	-9	-9	-5	-3	-1	---	-33	-51
3. Expand the qualified veterans' mortgage bond program (sunset 12/31/10)	[4]	[1]	[1]	-1	-2	-3	-5	-5	-5	-5	-5	-7	-32
4. Provide capital gains treatment for certain self-created musical works (sunset 12/31/10)	soei tyba DOE	---	-1	-5	-5	-4	-2	-4	---	---	---	-14	-20
5. Expand the eligibility for the tonnage tax election (minimum of 6,000 deadweight tons) (sunset taxable years ending before 1/1/11)	tyba 12/31/05	-2	-3	-4	-4	-4	-3	---	---	---	---	-17	-20
6. Modification of certain arbitrage rules for certain funds (include 20% State limitation) (sunset 8/31/09)	bia DOE	---	---	-1	-2	-1	[1]	[1]	---	---	---	-4	-5
7. Amortization of song rights (sunset 12/31/10)	ppisi tyba 12/31/05	1	3	2	1	-1	-3	-6	-5	-2	-3	6	-13
8. Modification to small issue bonds - accelerate effective date for increase in capital expenditure limit	bia 12/31/06	---	-2	-9	-15	-18	-18	-18	-18	-18	-18	-44	-136
9. Modification of treatment of loans to qualified continuing care facilities (sunset 12/31/10)	[5]	[1]	-3	-2	-2	-2	-1	---	---	---	---	-10	-10
Total of Other Provisions		**-4**	**-22**	**-38**	**-48**	**-54**	**-54**	**-52**	**-46**	**-41**	**-41**	**-167**	**-403**

Provision	Effective	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-10	2006-15
III. Individual AMT Provisions													
1. Increase individual AMT exemption amount for 2006 to $42,500 ($62,550 Joint) (sunset 12/31/06)	tyba 12/31/05	-12,419	-18,628	---	---	---	---	---	---	---	---	-31,047	-31,047
2. Treatment of nonrefundable personal credits under the individual alternative minimum tax (sunset 12/31/06) [6]	tyba 12/31/05	-565	-2,260	---	---	---	---	---	---	---	---	-2,825	-2,825
Total of Individual AMT Provisions		**-12,984**	**-20,888**	---	---	---	---	---	---	---	---	**-33,872**	**-33,872**
IV. Corporate Estimated Tax Provisions													
1. Increase corporate estimated tax payments due July through September for corporations with assets in excess of $1 billion in certain years (increase to 105% in 2006, 106.25% in 2012, and 100.75% in 2013 of the otherwise required amount)	DOE	2,209	-2,209	---	---	---	---	3,189	-2,793	-396	---	---	---
2. Delay due date until October 1 for a percentage of corporate estimated taxes that are otherwise due on September 15 in certain years (20.5% in 2010 and 27.5% in 2011)	DOE	---	---	---	---	-5,640	-2,541	8,182	---	---	---	-5,640	---
Total of Corporate Estimated Tax Provisions		**2,209**	**-2,209**	---	---	**-5,640**	**-2,541**	**11,371**	**-2,793**	**-396**	---	**-5,640**	---
V. Revenue Offset Provisions													
1. Application of earnings stripping rules to partners which are C corporations	tybo/a DOE	2	23	25	27	29	31	33	35	38	41	106	284
2. Reporting of interest on tax-exempt bonds	ipa 12/31/05	[7]	2	2	2	2	3	3	3	3	3	9	24
3. 5-year amortization of geological and geophysical costs for major integrated oil companies	apoia DOE	5	28	49	48	30	10	3	4	6	6	160	189
4. Treatment of distributions attributable to FIRPTA gains (including application of FIRPTA to RICs, and prevention of avoidance through wash sales) [8]	various	1	3	3	3	3	3	3	3	3	3	13	28
5. Section 355 not to apply to distributions involving disqualified investment companies	da DOE	2	9	11	12	12	12	12	15	15	16	46	116
6. Loan and redemption requirements on pooled financings (30% first-year loan origination requirement)	bia DOE	16	35	39	40	42	44	46	49	52	54	172	417
7. Require partial payments with submissions of offers-in-compromise (permanent 24-month rule)	osoaa 60da DOE	---	160	172	185	199	214	230	247	265	285	715	1,955
8. Increase in age of minor children whose unearned income is taxed as if parent's income	tyba 12/31/05	56	145	203	219	153	204	242	260	298	349	776	2,128
9. Withholding on government payments (including payments under certificate or voucher programs) for property and services	pma 12/31/10	---	---	---	---	---	6,079	215	220	228	235	---	6,977
10. Eliminate the income limitations on Roth IRA conversions; taxpayers can elect to pay tax on amounts converted in 2010 in equal installments in 2011 and 2012	tyba 12/31/09	---	---	---	-154	-293	2,541	4,929	1,756	-1,080	-1,267	-447	6,432
11. Repeal of FSC/ETI binding contract relief	tyba DOE	6	209	144	72	36	18	9	5	2	1	467	502
12. Modify wage limitation for section 199 to include only wages allocable to domestic production gross receipts and repeal special rule limiting amount of W-2 wages allocated by pass-thru entities	tyba DOE	1	7	8	9	19	24	26	28	29	31	43	181
13. Amend section 911 housing exclusion and impose a stacking rule and provide regulatory authority to allow for geographic differences	tyba 2005	15	261	199	206	222	228	234	239	254	268	903	2,126

Provision	Effective	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2006-10	2006-15
14. Tax involvement of accommodation parties in tax shelter transactions	[9]	---	18	31	35	40	46	53	62	69	75	123	428
Total of Revenue Offset Provisions		**104**	**900**	**886**	**704**	**494**	**9,457**	**6,038**	**2,926**	**182**	**100**	**3,086**	**21,787**
NET TOTAL		**-10,757**	**-23,231**	**-6,765**	**-18,458**	**-10,745**	**147**	**105**	**85**	**121**	**423**	**-69,960**	**-69,084**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. Date of enactment is assumed to be July 1, 2006. Provisions are estimated relative to the Congressional Budget Office baseline of January, 2005.

Legend for "Effective" column:

aafea = accounts and funds established after
apoia = amounts paid or incurred after
bia = bonds issued after
da = distributions after
DOE = date of enactment
ipa = interest paid after
osoaa = offers submitted on and after
pma = payments made after
ppisi = property placed in service in
soei = sales or exchanges in
tyba = taxable years beginning after
tybo/a = taxable years beginning on or after
60da = 60 days after

[1] Loss of less than $500,000.
[2] Effective for taxable years of foreign corporations beginning after December 31, 2006, and before January 1, 2009, and to taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.
[3] Effective for taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and to taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.
[4] Modification of definition of a qualified veteran is effective for bonds issued on or after the date of enactment. New State volume limitation is effective for allocations of State volume limits after April 5, 2006.
[5] Effective for calendar years beginning after December 31, 2005, with respect to loans made before, on, or after such date.
[6] The "Economic Growth and Tax Relief Reconciliation Act of 2001" provides that the child tax credit and adoption tax credit are allowed for purposes of the alternative minimum tax for 2002 through 2010. For purposes of the alternative minimum tax, the proposal does not treat the alternative motor vehicle credit and the alternative fuel vehicle refueling property credit as nonrefundable personal credits.
[7] Gain of less than $500,000.
[8] Some of the provisions sunset December 31, 2007.
[9] Effective for taxable years ending after the date of enactment, with respect to transactions before, on, or after such date, except that no tax applies to income or proceeds that are properly allocable to the period ending 90 days after the date of enactment; effective for disclosures due after the date of enactment.

WM. THOMAS,
JIM MCCRERY,
DAVE CAMP,
Managers on the Part of the House.

CHUCK GRASSLEY,
JON KYL,
Managers on the Part of the Senate.

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