U.S. Senate
Republican Policy
Committee

Legislative Notice

Jon Kyl, Chairman

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S. 2020 – Tax Relief Act of 2005

Reported by the Finance Committee on November 15, 2005, by a vote of 14 to 6; no written report.

NOTEWORTHY

- On November 16, 2005, the Senate will take up S. 2020, the Tax Relief Act of 2005. In addition to the strict rules governing floor consideration of reconciliation measures, floor debate on the bill is limited to 20 hours. However, amendments can still be offered once the debate time has expired. It is the Majority Leader's intention to complete action on the bill by Friday, and a "vote-a-rama" is expected at the conclusion of the debate on the bill.

- Under the FY 2006 budget resolution adopted by Congress (H. Con. Res. 95), the Senate Finance Committee was required to report a revenue reconciliation bill that consists of changes in the laws within its jurisdiction sufficient to reduce revenues by not more than $11 billion for FY 2006 and not more than $70 billion for the period of FY 2006 through FY 2010.

- Because the conference report to the Deficit Reduction Omnibus Reconciliation Act of 2005 (S. 1932) has not yet been completed, the total limit for the bill has been reduced to $60 billion over the five-year period in order to preserve the bill's reconciliation protection.

- Overall, the bill is designed to continue existing tax policy and avoid significant tax increases in the five-year period by extending certain expiring provisions, including the low-income savers credit, deduction for tuition, increased exemption from the Alternative Minimum Tax (AMT), small business expensing provisions, deduction for state and local taxes, research and experimentation tax credit, and other expiring tax provisions.

Background

Under the FY 2006 budget resolution adopted by Congress (H. Con. Res. 95), the Senate Finance Committee was required to report a revenue reconciliation bill that consists of changes in the laws within its jurisdiction sufficient to reduce revenues by not more than $11 billion for FY 2006 and not more than $70 billion for the period of FY 2006 through FY 2010. Because of the interaction between the bill and the Deficit Reduction Omnibus Reconciliation Act of 2005 (S. 1932), the total amount of revenue-reduction under the bill has been reduced to $60 billion over the five-year period, until the conference report to the bill is filed in the House of Representatives. The reduced limit is intended to preserve the bill's reconciliation protection.

On November 15, 2005, the Finance Committee reported favorably an original bill, the "Tax Relief Act of 2005," by a vote of 14 to 6. The bill is designed to extend various tax provisions that will expire over the next five years in order to maintain consistent and stable tax policy for the nation. A complete list of expiring tax provisions is available on the Joint Committee on Taxation's website at: http://www.house.gov/jct/x-12-05.pdf.

Bill Provisions

The following overview of the bill's provisions is based on materials prepared by the Senate Finance Committee. A complete description of the Chairman's mark of the "Tax Relief Act of 2005" is available at: http://finance.senate.gov/sitepages/leg/110805chrmktx.pdf. In addition, a description of the Chairman's modification to the bill is available at: http://finance.senate.gov/sitepages/leg/111405modmk.pdf.

I. <u>Hurricane Tax Relief</u>

Establishment of a Gulf Opportunity Zone **–** The bill establishes a Gulf Opportunity Zone ("GO Zone") in those areas of Alabama, Louisiana, and Mississippi that have been designated by the federal government as counties and parishes warranting individual or individual and public assistance by reason of Hurricane Katrina.

Bonus Depreciation **–** Current law allows businesses to recover the costs of new equipment over the economic life of the property. The bonus depreciation provisions in the bill permits businesses to expense 50 percent of the cost of new equipment placed in service in the GO Zone in the first year. Property that qualifies for bonus depreciation would include certain commercial and residential rental real estate as well as equipment. Investments would not be subject to the depreciation preference under the AMT. This provision would apply to property placed in service in the Gulf Opportunity Zone through 2007 and to real property through 2008.

Increase in Expensing for Small Businesses **–** Current law permits certain small businesses to deduct up to $100,000 of the cost of property used in the business. The bill doubles this amount to $200,000 for qualifying expenditures made in the disaster area through 2007. This provision also increases the phase-out level from $400,000 to $1 million of qualifying purchases, thus allowing more businesses to use this tax benefit in the GO Zone.

Additional Private Activity Bond Authority **–** The bill authorizes the issuance of qualified private-activity bonds by the States of Alabama, Louisiana, or Mississippi, or any of their political subdivisions, in excess of their current private-activity-bond limits. The maximum aggregate face amount of these "GO Zone bonds" would be limited to an amount equal to $2,500 per person in the respective GO Zones of Alabama, Louisiana, and Mississippi, based on 2004 population estimates. Bond interest on the GO Zone bonds would not be subject to the AMT.

Additional Advance Refunding for Bonds **–** The bill permits an additional advance refunding of certain governmental bonds issued by the States of Alabama, Louisiana, or Mississippi, or any of their political subdivisions, and certain 501(c)(3) bonds prior to January 1, 2007.

Increase in Funding for Low-Income Housing **–** Under current law, states receive allocations of low-income housing tax credits based on population. The bill allows states to allocate additional housing credit amounts in years 2006 to 2009 of up to three times the normal allocation with respect to the population in each state's GO Zone (for Alabama, Mississippi, and Louisiana). Under the bill, the Gulf Opportunity Zone is also treated as a high-cost area for purposes of the low-income housing credit for property placed-in-service in calendar years 2006, 2007, 2008, and 2009. Therefore, buildings located in the Gulf Opportunity Zone are eligible for the enhanced credit.

Treatment of Representations Regarding Income Eligibility for Qualified Residential-Rental Project Requirement **–** Under the bill, the operator of a qualified residential-rental project may rely on the representations of prospective tenants displaced by reason of Hurricane Katrina for purposes of determining whether such individuals satisfy the income limitations for qualified residential-rental projects. This rule only applies if the tenancy starts during the six-month period beginning on the date when such individual was displaced by Hurricane Katrina.

New Markets Tax Credit **–** The bill provides $1 billion from 2005 through 2007 in New Markets Tax Credit authority and to Community Development Entities with hurricane rebuilding and recovery as a significant mission. The bill also increases the maximum amount of qualified equity investments to $3.5 billion for 2008, and requires that the Treasury Department prescribe regulations to ensure that non-metropolitan counties receive a proportional allocation of qualified equity investments.

Net Operating Loss Carryback **–** The bill extends the period for carrying back net operating losses from 2 years to 5 years for net operating losses attributable to (i) new investment and repairing existing investment in the areas damaged by Hurricane Katrina, (ii) business casualty losses caused by Hurricane Katrina, and (iii) moving expenses and temporary housing expenses for employees working in areas damaged by Hurricane Katrina.

Public Utility Casualty Loss Carryback **–** Under the bill, taxpayers with casualty losses associated with public-utility property caused by Hurricane Katrina can elect to either (i) carry back a net operating loss attributable to certain casualty losses for 10 years, or (ii) treat certain casualty losses as having occurred 5 years prior to the disaster.

Increased Expensing and NOL Carryback for Qualified Timber Property **–** Under current law, taxpayers may only deduct $10,000 of reforestation costs. The bill raises the limit to $20,000 and allows losses to be carried back for 5 years, rather than the current 2-year period. The proposal only applies to taxpayers owning less than 500 acres of timber in the areas affected by Hurricanes Katrina, Rita, and Wilma.

Partial Expensing for Demolition and Cleanup Costs **–** Under the bill, 50 percent of the costs (that would otherwise be capitalized) related to site cleanup and demolition as a result of Hurricane Katrina would be deductible by businesses.

Expensing to Promote Cleanup of Brownfields **–** The bill extends the deductibility of costs of cleaning up hazardous sites (i.e., "brownfields") in the Katrina GO Zone for 2 years and allows expensing for the cleanup of petroleum products in the Katrina GO Zone.

Employee Retention Credit **–** The Katrina Emergency Tax Relief Act of 2005 (Public Law 109-73, September 23, 2005) provided a 40-percent tax credit for wages paid up to $6,000 if paid after August 28, 2005, and before December 31, 2005, by employers located in the Katrina GO Zone with an average of 200 or fewer employees. The bill modifies the tax credit so that it applies without regard to the size of the employer.

Relaxed Restrictions on Mortgage-Revenue Bonds **–** Mortgage-revenue bonds are tax-exempt bonds that state and local governments generally issue through housing finance agencies. The proceeds from the bonds are used to fund below-market-interest-rate mortgages for certain first-time home buyers who meet income and purchase-price restrictions. The bill provides greater access to mortgage-revenue-bond proceeds with respect to Katrina by lifting the first-time homeowner requirement and by allowing up to $150,000 in mortgage-revenue-bond proceeds to be used for repairs through December 31, 2010. The bill also relaxes the income and purchase-price restrictions with respect to mortgage-revenue bonds funded with Katrina GO Zone bonds.

Expansion of the HOPE and Lifetime Learning Credits for Students in the Gulf Recovery Zone **–** The bill expands for 2005 and 2006 the Hope and Lifetime Learning credits for students attending eligible education institutions located in the Gulf Recovery Zone. Under the bill, the Hope credit is increased to 100 percent of the first $2,000 in qualified tuition and related expenses and 50 percent on the next $2,000, for a maximum credit of $3,000 per student. The Lifetime Learning credit rate is increased from 20 percent to 40 percent. The bill also expands the definition of qualified expenses to include expenses associated with books, transportation, and room and board.

Additional Relief Related to Hurricanes Rita and Wilma **–** The bill extends to the victims of Hurricane Rita the individual relief already provided (or which will be provided through the bill) to victims of Hurricane Katrina:

- ***Relaxed Restrictions on Mortgage-Revenue Bonds*** **–** The bill allows greater access to mortgage-revenue-bond proceeds by lifting the first-time homeowner requirement through December 31, 2010, for homes in certain areas damaged by Hurricanes Rita and

Wilma. In addition, the provision allows up to $150,000 of the loan proceeds to be used for hurricane-related repairs to damaged homes.

- ***Early Withdrawals from Retirement Plans* –** Present law discourages distributions from tax-preferred retirement plans (e.g., Individual Retirement Accounts, 401(k) plans) with penalties and other limitations. As provided by the Katrina Emergency Tax Relief Act for victims of Hurricane Katrina, the bill waives the 10-percent penalty for premature distributions from IRAs and qualified retirement plans for individuals who suffered an economic loss because of Hurricanes Rita or Wilma and whose principal residence is located in the Rita or Wilma disaster areas. Individuals eligible for this waiver would be permitted to pay income tax on such distributions ratably over a 3-year period. Taxpayers would be permitted to re-contribute amounts distributed back to a qualified retirement plan over the 3-year period following the distribution date and receive rollover treatment. The waiver of the 10-percent penalty, 3-year income averaging, and re-contribution provisions for retirement plan withdrawals will be limited to $100,000 per individual. Distributions for home purchases that were not finalized because of Hurricanes Rita or Wilma could also be re-contributed to a qualified retirement plan or IRA. Limitations on loans from qualified employer plans would be increased for victims of Hurricanes Rita and Wilma by doubling the thresholds to the lesser of $100,000 or 100 percent of the individual's account balance. Payments due from hurricane victims on qualified plan loans on or after August 25, 2005, and before January 1, 2007, could be deferred and the maximum repayment period extended by 12 months.

- ***Employee Retention Credit for Small Businesses* –** As already provided for employers in the Katrina GO Zone, the bill establishes a 40-percent tax credit for wages paid up to $6,000 if paid after August 28, 2005, and before December 31, 2005, by employers located in the disaster zones of Hurricane Rita or Wilma without regard to the size of the employer. The employee's usual and principal place of work must have been in the disaster zone, but the credit is not affected if the employee reports to work at another location. Wages paid to relatives would be ineligible for the credit.

- ***Corporate Charitable Contributions* –** The amount allowed as a charitable deduction for a corporation in any taxable year may not exceed 10 percent of the corporation's taxable income. The bill temporarily waives limits regarding charitable cash contributions for Rita and Wilma relief. The provision is effective for contributions before January 1, 2006. This provision parallels the temporary waiver provided in the Katrina Emergency Tax Relief Act for contributions relating to Katrina relief.

- ***Casualty Loss Provision* –** Under present law, non-business casualty losses are deductible by taxpayers who itemize only to the extent they exceed 10 percent of adjusted gross income (AGI) and a $100 floor. In some circumstances, taxpayers are permitted to include a current-year casualty loss on an amended prior-year return. As provided by the Katrina Emergency Tax Relief Act for losses relating to Hurricane Katrina, the bill eliminates the 10-percent and $100-floor for casualty losses resulting from Hurricanes Rita or Wilma and incurred in the disaster area, including those claimed on amended returns.

II. Expiring Tax Provisions

***Small Business Expensing* –** The 2003 tax act increased the amount that small businesses may expense from $25,000 to $100,000 for three years (through the end of 2005). The American Jobs Creation Act of 2004 (the "JOBS" Act) extended a slightly expanded version of small business expensing (with higher phase-out levels for small business) through 2007. The bill extends the current enhanced provision for small business expensing through 2009.

***Savers Credit* –** The Economic Growth and Tax Relief Reconciliation Act of 2001 (2001 tax act) provided a temporary non-refundable tax credit for contributions made by eligible taxpayers to certain qualified retirement plans (e.g., 401(k), 403(b), annuity, SIMPLE, SEP, traditional and Roth IRAs) through the end of 2006. The maximum annual contribution for the credit is $2,000, with the credit rate depending on the adjusted gross income of the taxpayer. Only taxpayers with AGI of $25,000 or less ($50,000 for married couples) are eligible for the credit. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The bill extends the savers credit through 2009.

***Tuition Deduction* –** The 2001 tax act created a new above-the-line tax deduction for qualified higher-education expenses paid during tax years 2002 through 2005. Currently, the maximum deduction is $4,000 for taxpayers with AGI of $65,000 or less ($130,000 for married couples) or $2,000 for taxpayers with AGI of $80,000 or less ($160,000 for married couples). The bill extends the provision through 2009.

***State and Local Taxes* –** The JOBS Act provided that for tax years 2004 and 2005, a taxpayer may elect to take an itemized deduction for state and local general sales taxes in lieu of the itemized deduction permitted for state and local income taxes. Taxpayers were given two options for determining deductible sales tax: (i) actual sales tax paid if receipts are maintained for verification by the Internal Revenue Service, or (ii) approximate sales tax paid as estimated in tables provided by the Secretary of the Treasury. The bill extends the provision through 2006.

***AMT Exemption Levels* –** The 2003 tax act increased the AMT exemption amount to $40,250 for single taxpayers and $58,000 for married couples filing jointly for 2003 and 2004 to prevent new taxpayers from becoming subject to the alternative minimum tax (AMT). The Working Families Tax Relief Act of 2004 extended those exemption amounts through the end of 2005. The bill extends the increased exemption amounts through the end of 2006 and indexes them for inflation.

***Non-refundable Personal Credits Against Regular and Alternative Minimum Tax Liability* –** Certain non-refundable personal tax credits (including dependent care, elderly and disabled, Hope Scholarship and Lifetime Learning, and the D.C. home buyer) are allowed only to the extent that a taxpayer has regular income tax liability in excess of the tentative minimum tax, which has the effect of disallowing these credits against AMT. Temporary provisions have been enacted that permit these credits to offset the entire regular and AMT liability through the end of 2005. The proposal allows all of the non-refundable personal tax credits, and the non-business portion of the tax credits for alternative motor vehicles and alternative motor vehicle refueling property, to the full extent of the individual's regular tax and AMT for taxable years beginning in 2006.

Extension and Expansion of the Research and Development Tax Credit – Current law provides a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenses for a taxable year exceed its base amount for that year. The bill expands the current-law research credit to include a new Alternative Simplified Credit (ASC) for research expenditures, and it extends the research credit (set to expire at the end of 2005) to qualified amounts paid or incurred during 2006.

Extension and Modification of the Work Opportunity Tax Credit (WOTC) and Welfare to Work (WTW) – Under current law, the WOTC and WTW tax credits are set to expire at the end of 2005. The bill combines and extends those tax credits for one year. Key modifications of the combined credit would include expanded eligibility for WOTC (e.g., higher age ceiling for food-stamp recipients from 25 to 40) and revised eligibility requirements for ex-felons.

Qualified Zone Academy Bonds (QZABs) – QZABs are tax-credit bonds issued by states or localities principally for school renovation. The bonds allow the bond holder to claim a tax credit against federal income taxes in lieu of receiving interest. The bill extends the provision for one year and authorizes states to issue up to $400 million of QZABs for 2006. Similar to recently enacted tax-credit bond proposals, the proposal applies yield-restriction and arbitrate-rebate requirements, and it imposes a requirement that the issuer reasonably expect to and actually spend the proceeds on QZAB property within five years of the date of issue. The bill also requires the use of cash or cash equivalents to meet the current-law match requirement.

Enhanced Deduction for Corporate Contributions of Computer Equipment for Educational Purposes – A provision under current law, which expires at the end of 2005, encourages businesses to contribute computer equipment software to elementary, secondary, and post-secondary schools by allowing an enhanced deduction for such contributions. The bill extends the computer deduction provisions through the end of 2006.

Deduction for Certain Expenses of Elementary and Secondary School Teachers – In 2002, Congress began permitting teachers and other school professionals to claim an above-the-line deduction of up to $250 for expenses paid or incurred for books, certain supplies, computer equipment (including related software and services), other equipment, and supplementary materials used by the educator in the classroom. This provision expires at the end of 2005, and the bill extends it for an additional year.

Brownfield Remediation Expensing – Current law permits expensing of costs associated with cleaning up hazardous sites (i.e., "brownfields") through December 31, 2005. The bill extends the current provision through the end of 2006 and allows expensing for the cleanup of petroleum products.

Tax Incentives for Investment in the District of Columbia – The bill extends four provisions intended to encourage redevelopment, capital investment, and home ownership in financially-distressed areas of the District of Columbia for an additional year: (1) designation of the D.C. enterprise zone, employment tax credit, additional expensing; (2) tax-exempt D.C.

empowerment zone bonds; (3) 0-percent capital-gains rate for investment in D.C. property; and (4) tax credit for first-time D.C. home buyers.

Indian Employment Tax Credit – Under current law, a business tax credit is available for employers of qualified employees who work and live on or near an Indian reservation. The credit, which expires at the end of 2005, is for wages and health-insurance costs paid to qualified employees (up to $20,000) in the current year over the amount paid in 1993. Wages for which the work opportunity tax credit is available are not qualified wages for the Indian employment tax credit. The bill extends the provision through 2006.

Accelerated Depreciation for Business Property on Indian Reservations – Current law provides a special depreciation recovery period for qualified Indian reservation property placed in service before January 1, 2005. In general, qualified Indian reservation property is property used predominantly in the active conduct of a trade or business within an Indian reservation. The bill extends the provision for an additional year.

Leasehold Improvement Recovery – The JOBS Act shortened the depreciation period for leasehold improvements from 39 years to 15 years through 2005. The bill extends that provision through the end of 2006.

III. Charitable-Giving Incentives

Non-Itemizer/Itemizer Deduction – The bill provides for a charitable deduction for cash donations made by taxpayers who do not itemize their deductions (approximately 74 percent of filers currently cannot take a charitable deduction because they do not itemize). The bill creates a floor of $210 for single filers ($420 for joint filers) that applies to both taxpayers who do not itemize and those that do. The new deduction is not subject to an income cap. In conjunction with expansion of charitable deductions, the bill provides improved anti-abuse rules for recordkeeping and substantiation of charitable donations for cash and non-cash items (e.g., clothing and household items).

Tax-Free Distributions From IRAs for Charitable Purposes – The bill provides an exclusion from gross income for certain distributions from a traditional or a Roth IRA, which would otherwise be taxable. To qualify, the charitable distribution must be made either to (1) a tax-exempt organization to which deductible contributions can be made, or (2) a "split-interest entity," such as a charitable remainder annuity trust or charitable remainder unitrust, a pooled income fund, or a charitable gift annuity. Special rules apply to IRAs that include non-deductible contributions to determine the portion of a distribution that is eligible to be a qualified charitable distribution.

Charitable Deduction for Contributions of Food Inventory – For donations of food inventory by qualifying businesses, the bill provides an enhanced deduction equal to the lesser of the fair market value or twice the taxpayer's basis in the contributed inventory. The enhanced deduction is available only for food that qualifies as "apparently wholesome food," which 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.

***Basis Adjustment to Stock of S Corporation Contributing Property* –** The bill provides that the amount of a shareholder's basis reduction in the stock of an S corporation, by reason of a charitable contribution made by the corporation, will be equal to the shareholder's pro rata share of the adjusted basis of the contributed property.

***Tax Treatment of Certain Payments to Controlling Exempt Organizations* –** Under current law, rent, royalty, annuity, and interest income received by a taxable or tax-exempt subsidiary that is controlled by a parent tax-exempt organization is generally treated as unrelated business income, which is taxable to tax-exempt parent organizations. The bill provides that this rule applies only to the portion of payments received or accrued in a taxable year that generally exceeds the fair market value of the specified payment.

***Charitable Deduction for Contributions of Book Inventory* –** The bill modifies the current-law deduction for contributions of qualified book inventory by C corporations, making the deduction equal to the lesser of the fair market value or twice the taxpayer's basis in the contributed property. The fair market value for this purpose is determined by reference to a bona fide published market price for the book. A qualified book contribution means a charitable contribution of books to (1) an educational organization, (2) a public library, or (3) a tax-exempt organization with the primary purpose of making books available to the general public at no cost or to operate a literacy program.

***Involvement by exempt organizations in tax-shelter transactions* –** The bill subjects certain tax-exempt entities to penalties for participating in a prohibited tax-shelter transaction as accommodation parties. A prohibited tax-shelter transaction is generally any transaction that the Treasury Secretary determines is a listed transaction or a reportable transaction as defined under current law. The bill also clarifies that an exempt organization that participates in a reportable transaction (including a listed transaction) in order to shelter from tax the organization's own tax liability (e.g., the unrelated business income tax) is subject to the current-law rules pertaining to disclosure of such transactions.

***Reform of Certain Life Insurance Contracts* –** In general, the bill 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 tax-exempt organization and any person that is not a tax-exempt organization have, directly or indirectly, held an interest in the contract. The provision is subject to a de minimis rule for certain interests held as part of a diversified strategy. The bill also provides regulatory authority for the Treasury Department to except certain contracts from treatment as applicable insurance contracts.

***Fines and Penalties Applicable to Charitable Organizations* –** In general, the bill doubles the amount of excise taxes applicable to certain activities by private foundations and private foundation managers, and it increases the dollar limitations applicable to excise taxes on managers of public charities, private foundations, and social-welfare organizations.

***Donor-Advised Funds* –** The bill requires that donor-advised funds make an aggregate payment in each taxable year equal to 5 percent of the aggregate asset balance of all donor-advised funds maintained by the sponsoring organization during the taxable year. The bill permits the use of set-asides (e.g., such as saving money for a building), and permits them to count toward the payout requirement. The bill includes anti-abuse provisions with respect to the new donor-advised-fund rules.

***Supporting Organizations* –** The bill generally applies the current anti-abuse rules with respect to excess business holdings by private foundations to supporting organizations. Under the bill, supporting organizations must generally pay, in each taxable year, to one or more public charities the sum of (1) the greater of (i) 85 percent of its income or (ii) 5 percent of the aggregate fair market value of all of the assets of the organization (other than those used directly in supporting charitable programs), and (2) any repayments of amounts that were taken into account as support provided by the supporting organization in prior years. In addition, a new supporting organization may not support more than five organizations, and the supporting organization must notify in writing each organization designated for support. Anti-abuse provisions apply to supporting organizations that support an organization that the donor controls.

***Charitable Contributions of Facade Easements* –** Under the bill, a charitable deduction is allowable with respect to easements concerning buildings located in a registered historic district, but the qualified real-property interest that relates to the exterior of the building must preserve the entire exterior of the building, not merely its facade. In addition, the easement must provide that no portion of the exterior of the building may be changed or altered in a manner inconsistent with the historical character of such exterior. The bill requires that charities accepting easement donations must be accredited by the National Trust for Historic Preservation – starting in 2008. For certain large easement deductions, the bill also imposes a user fee and applies expanded reporting requirements and appraisal requirements.

***Taxidermy and Substantiation of Exempt Use Property* –** For contributions of exempt-use taxidermy property with a claimed value of more than $500 but not more than $5,000, the taxpayer must supply the IRS with a photograph of the taxidermy and comparable sales data for similar items within the previous six months. For claims of more than $5,000, the taxpayer must request a Statement of Value from the IRS (currently available for art and collectibles).

***Partial Interest in Donated Property* –** The bill requires that charities receiving a fractional interest in an item of tangible personal property must take actual possession of the item for a period of time corresponding substantially to the charity's percentage interest in the item.

***Appraisal Reform* –** The bill lowers the thresholds for imposing accuracy-related penalties on a taxpayer who claims a deduction for donated property, for which a qualified appraisal is required (i.e., appraisals are required for donations of over $5,000, under current law). The bill also provides definitions of a qualified appraiser and qualified appraisals.

***Credit Counseling* –** The bill imposes certain restrictions on tax-exempt organizations that offer credit-counseling services. In order to stem abusive situations, the bill imposes restrictions on organizations offering credit-counseling services with respect to fees, solicitation of contributions from consumers receiving counseling, and the portion of the organization's total activities committed to credit counseling.

IV. Miscellaneous Provisions

***Restructure of the New York Liberty Zone Tax Incentives* –** The bill repeals the four New York Liberty Zone tax incentives enacted after September 11, 2001, relating to the additional first-year depreciation allowance, the 5-year depreciation of leasehold improvements, the additional small business expensing, and the extended replacement period for involuntary conversions. In their place, the bill provides a new tax credit for New York State and New York City with respect to certain transportation-infrastructure projects, including highways, mass transit systems, railroads, airports, ports, and waterways, in or connecting with the New York Liberty Zone.

***Treatment of S Corporation Passive-Investment Income* –** Under current 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. The bill increases the 25-percent threshold to 60 percent, and it eliminates the current-law rule under which an S Corporation's favorable tax status is terminated by reason of having passive-investment income for three consecutive taxable years.

***Capital Expenditure Limitation for Qualified Small Issue Bonds* –** Under current law, state and local government may issue certain tax-exempt bonds (i.e., "qualified small-issue bonds") to finance private business manufacturing facilities or the acquisition of land and equipment by certain farmers. In general, a $10 million cap applies to small-issue bond financing for property of a business located in the same municipality or county. That limit is scheduled to increase to $20 million for bonds issued after September 30, 2009. The bill accelerates the application of the increased limitation to bonds issued after December 31, 2006.

***Mortgage-Insurance Tax Deduction* –** The bill provides that mortgage-insurance premiums may be deducted like mortgage interest payment with respect to a residence. The deduction is phased out for taxpayers with AGI in excess of $100,000 ($50,000 for a married individual filing a separate return). The deduction is not allowed if the taxpayer's AGI exceeds $110,000 ($55,000 in the case of a married individual filing a separate return). The new deduction applies to payment of mortgage-insurance premiums in tax year 2007.

V. Revenue Offsets

***Understatement of Taxpayer's Liability by Income Tax Return Preparer* –** The bill raises the standard that tax preparers must meet to avoid penalties.

***Modification of Suspension of Interest and Penalties Where IRS Fails to Contact Taxpayer* –** This provision of the bill is directed toward investors in abusive tax-avoidance transactions that have been designated as "listed transactions" by the IRS. Generally, the bill eliminates the 18-month suspension of interest that normally applies if the IRS does not notify the taxpayer of its tax liability within 18 months of the return due date.

***Frivolous Tax Submissions* –** The bill increases the penalty for frivolous tax submissions from $500 to $5,000 and expands the penalty to apply to all taxpayers and all types of federal taxes, including submissions for collection due process, installment agreements, offers-in-compromise, and taxpayer-assistance orders. This provision becomes effective for all submissions and issues raised after the date on which the Treasury Secretary prescribes the list of frivolous positions required under the bill.

***Clarification of the Economic Substance Doctrine and Penalty for Understatements Attributable to Transactions Lacking Economic Substance* –** The bill clarifies the application of the economic-substance doctrine but does not change current-law standards used by courts in determining when to utilize an economic-substance analysis. Under the provision, in any case in which a court determines that the economic-substance doctrine is relevant to a transaction, the economic-substance doctrine would be satisfied only if (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. The bill also imposes a 40-percent penalty on understatements attributable to a non-economic-substance transaction (unless the transaction was disclosed, in which case the penalty is 20 percent). This provision becomes effective for transactions entered into after the date of enactment.

***Denial of Deduction for Interest on Underpayments Attributable to Non-Economic Substance Transactions* –** The bill denies any deduction for interest on unpaid taxes attributable to any understatement resulting from a non-economic-substance transaction. This provision becomes effective for transactions entered into after the date of enactment.

***Waiver of User Fee for Installment Agreements Using Automated Withdrawals* –** Current law imposes a $43 user fee on taxpayers entering into an installment agreement with the IRS. The bill waives the user fee if the taxpayer agrees to automated withdrawal of installment payments from a bank account.

***Termination of Installment Agreements* –** Although a significant number of taxpayers violate the terms of their installment agreements by failing to file their tax returns or make required federal tax deposits on a timely basis, the IRS is not permitted to terminate installment agreements for these reasons. The bill allows installment agreements to be terminated for failure to file tax returns and failure to make deposits and would be effective for failures occurring after the date of enactment.

***Offers-In-Compromise Partial Payments* –** The bill requires that a taxpayer make a good-faith down payment with any application for an offer-in-compromise equal to 20 percent of any lump-sum offer. For offers involving periodic payments, taxpayers are required to comply with their own payment schedule. The proposal also repeals the $150 user fee and reduces the time for the IRS to accept an offer from 24 months to 12 months beginning in 2010.

***Increased Criminal Fines and Penalties* –** The bill increases criminal fines and prison sentences for the three most common offenses: failure to file, filing a false or fraudulent return, and tax evasion. These proposed changes are substantially similar to the increased criminal penalty provisions passed by the Senate in the JOBS Act. One notable change is the creation of a new aggravated failure-to-file offense. While retaining the current misdemeanor penalty for non-filers, which is necessary to address simple violations, the new provision creates an aggravated offense to address more serious instances of noncompliance (i.e., "aggravated" means failing to file for three or more years with an aggravated tax liability of $100,000 or more).

***Doubled Penalties for Concealment of Income Using Offshore Accounts* –** The bill doubles penalties, interest, and fines on taxpayers who deliberately conceal taxable income by using offshore accounts. This provision applies to taxpayers who have an offshore account and who have not signed a closing agreement in the IRS Offshore Voluntary Compliance Initiative (OVCI) or voluntarily disclosed participation in such arrangement to the IRS. This provision would become effective for taxpayers' open tax years on or after the date of enactment.

***Denial of Deduction for Certain Fines, Penalties, and Other Amounts* –** The bill clarifies that taxpayers may not deduct for federal income tax purposes amounts incurred or paid to the government in relation to a violation of any law or with respect to a governmental investigation or inquiry into the potential violation of any law. The provision would be effective for amounts paid or incurred on or after the date of enactment, unless they are paid under a binding order or agreement entered before that date.

***Deny Deduction for Punitive Damages* –** The bill eliminates the 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 both to the insured person and to the IRS. The proposal is effective for punitive damages that are paid or incurred on or after the date of enactment.

***Increase in Penalty for Bad Checks and Money Orders* –** The bill increases the penalty for bad checks with respect to tax payments. For checks of less than $1,250, the penalty would increase to the lesser of $25 or the amount of the check. This is an increase from the current threshold of less than $750 and the current penalty of $15. For amounts of $1,250 or more, the bill retains the current penalty of 2 percent of the check amount.

***Inversions* –** As part of the American Jobs Creation Act of 2004 (Public Law 108-357, October 22, 2004), Congress enacted provisions to stop U.S. corporations and partnerships from engaging in inversion transactions (i.e., in general, moving their headquarters from the United States to a low-tax jurisdiction) to escape future U.S. tax on their foreign earnings and gain the ability to reduce U.S. tax on their U.S. operations. The new rules apply to two types of inversion transactions that occurred after March 4, 2003. In the first type of transaction, a U.S. corporation becomes a subsidiary of a foreign-incorporated entity and the former shareholders of the U.S. corporation own 80 percent or more of the foreign-incorporated entity. These foreign-incorporated entities are treated as U.S. corporations for all U.S. income tax purposes. In the second type of transaction, former shareholders of the U.S. corporation own 60 percent or more, but less than 80 percent, of the foreign-incorporated entity. In these transactions, the foreign-incorporated entity is treated as foreign, but any applicable corporate-level "toll-charge" taxes are not offset by tax attributes, such as net operating losses or foreign tax credits. The new rules also apply to inversion transactions involving certain partnerships. A transaction otherwise meeting the definition of an inversion transaction will be excluded from the new rules if, on or before March 4, 2003, the foreign-incorporated entity had acquired more than half of the property held by the domestic corporation, or partnership's trade or business, as the case may be.

The bill makes several changes to the inversion rules. First, the rules would apply to transactions completed after March 20, 2002 (as opposed to March 4, 2003 under current law). Second, the provision would lower the 60-percent ownership threshold for the second category of inversion transactions under current law to 50 percent. The provision would increase the accuracy-related penalties and tighten the earnings-stripping rules with respect to companies involved in this type of transaction. Third, the provision would generally exclude from the inversion rules transactions involving non-publicly traded U.S. corporations.

***Impose Mark to Market on Individuals Who Expatriate* –** The bill generally imposes U.S. taxes on certain U.S. citizens who relinquish their U.S. citizenship and certain long-term residents who terminate their U.S. residency. The tax applies to the net unrealized gain in their property as if such property were sold for fair market value. 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). This provision becomes effective for U.S. citizens who expatriate or long-term residents who terminate their residency on or after the date of enactment.

***Modify the Tax Treatment of Contingent Convertible-Debt Instruments* –** The bill creates a consistent approach to value contingent convertible debt for purposes of computing original issue discount (OID). A "comparable rate" for a contingent convertible-debt instrument would be based on a non-contingent, convertible-debt instrument (and a non-convertible-debt instrument, as the IRS now applies the law).

***Grant Treasury Regulatory Authority to Address Foreign-Tax-Credit Transactions* –** The bill authorizes the Secretary of the Treasury to provide regulations that address abusive foreign-tax-credit schemes involving the inappropriate separation of foreign taxes from the related income. The provision becomes effective for transactions entered into after the date of enactment.

***Modification of Effective Dates of Leasing Provisions of the JOBS Act* –** The bill repeals an exceedingly generous grandfather rule, which permits an abusive leasing tax shelter in the transportation sector called "sale-in lease-out" transactions or SILOs. SILO schemes allow corporations to claim tax deductions for bridges, pipelines, and subways that are paid for with taxpayer dollars. Congress passed the JOBS Act in 2004, outlawing SILOS for leases entered into after March 12, 2004. However, an exception was provided for property located in the United States subject to a lease with respect to which a formal application (1) was submitted for approval to the Federal Transit Administration 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 fair market value of such property. The bill eliminates this exception.

***Application of Earnings-Stripping Rules to C Corporations Which are Partners* –** Current law provides rules to limit the ability of U.S. subsidiaries of foreign corporations to reduce U.S. tax on their U.S. source income through earnings-stripping transactions. The current earnings-stripping provision does not apply to partnerships. Proposed Treasury regulations provide that a corporate partner's proportionate share of partnership liabilities is treated as debt of the corporation for purposes of applying the earnings-stripping limitation to the corporation's own interest payments. The bill provides a rule that attributes partnership debt to the corporate partners for purposes of the earnings-stripping test.

***Limit Employer Deduction for Certain Entertainment Expenses* –** The bill limits an employer's deduction for expenses relating to goods, services, and facilities provided to an employee. The deduction is limited to the amount treated as compensation on the employer's tax return and as wages on the employee's tax return. In the case in which the recipient is not an employee, the employer's deduction is also limited to the amount of the expenses that must be included in the gross income of the recipient.

***Increase Age Limit Applicable to the "Kiddie Tax"* –** The bill generally increases the age of minors from 14 to 18 for purposes of subjecting the minor's unearned income to tax at the parents' tax rate (the so-called "kiddie tax").

***Loan and Redemption Requirements on Pooled Financing Bonds* –** The bill imposes new requirements on pooled financing bonds as a condition of tax exemption, including written loan commitments, loan-origination expectations, redemption requirements, and small-issuer exceptions.

***Information-Reporting Requirements for Interest on Tax-Exempt Bonds* –** Under the bill, interest paid on tax-exempt bonds is subject to information reporting in the same manner as interest paid on taxable obligations.

***Modification of the Non-Conventional Fuels Credit* –** The bill modifies the manner in which the phase-out of the non-conventional fuel credit is calculated by using the applicable fuel price in the prior taxable year, rather than the current year, as under current law. In addition, the bill generally repeals the phase-out limitation entirely for coke and coke gas, and it eliminates the inflation adjustment for all fuels other than coke and coke gas for 2005, 2006, and 2007.

***Modification of the Individual Estimated-Tax Safe Harbor* –** The bill provides that taxpayers with AGI above $150,000 in the prior tax year, who make estimated tax payments based on the prior year's tax, must do so based on 119 percent of the prior year's tax for estimated tax payments made for taxable year 2006. That percentage will revert back to 110 percent for taxable years 2007 and thereafter.

***Time for Making Corporate Estimated Tax Payments* –** Corporations are generally required to make quarterly estimated tax payments of their income tax liability. Under the bill, with respect to corporate estimated-tax payments due on September 15, 2010, 3 percent of the payment is required to be paid on October 1, 2010.

***Revaluation of LIFO Inventories of Large Integrated Oil Companies* –** Under current law, businesses are generally permitted to use a last-in, first-out (LIFO) method to account for their inventories, provided they use the same accounting method for other reporting purposes. When prices are rising (as with oil prices in recent months), the LIFO method generally reduces the business' income and its tax liability. The bill disallows, in effect, 75 percent of the LIFO-method benefit for integrated oil companies with gross receipts in excess of $1 billion. The proposal is effective for the most recent taxable year of relevant taxpayers ending in 2005.

Limitation on Amortization of Geological and Geophysical Expenditures by Major Integrated Oil Companies – The conference report to the Energy Tax Incentives Act of 2005 (Public Law 109-58, August 8, 2005) included a provision that allows geological and geophysical amounts incurred in connection with oil and gas exploration in the United States to be amortized over two years. The bill would eliminate this provision for large integrated oil companies.

Cost

The Joint Committee on Taxation (JCT) estimates that the bill will reduce federal tax revenues by a net $10.96 billion in FY 2006 and by $59.59 billion over five years, including offsets. Accordingly, the bill satisfies the Finance Committee's reconciliation instructions under the Budget Resolution (as modified to take into account the interaction with the Deficit Reduction Omnibus Reconciliation Act of 2005) with respect to FY 2006 and the period from FY 2006 through FY 2010.

With respect to the disaster relief included in the bill, the JCT estimates that those provisions will cost $6.99 billion over five years and $7.64 billion over ten years.

A copy of the JCT's revenue estimate is available at: http://www.house.gov/jct/x-80-05.pdf.

Administration Position

A Statement of Administration Policy (SAP) on the bill was not available at press time.

Possible Amendments

For the Finance Committee's markup of the bill, more than 100 amendments were filed on a broad range of issues, of which two were accepted and one was defeated. While the strict rules governing floor consideration of reconciliation measures will limit amendments only to issues addressed in the bill, a significant number of amendments are still possible. It is anticipated that a number of amendments will focus on energy-related tax provisions.