



May 11, 2006

## Highlights of the Conference Report to Accompany H.R. 4297, Tax Increase Prevention and Reconciliation Act of 2005

*The Conference Report to H.R. 4297, H. Rept. 109-455, was filed on May 9, 2006.*

### NOTEWORTHY

- On May 11, 2006, the Senate will consider the Conference Report to H.R. 4297, the Tax Increase Prevention and Reconciliation Act of 2005. Pursuant to a unanimous consent agreement, debate on the Conference Report is limited to 8 hours, equally divided.
- The Conference Report extends certain provisions of the tax code that have expired or will soon expire, including expensing for equipment purchases by small businesses, relief from the Alternative Minimum Tax (AMT), and the lower tax rates on dividends and capital gains.
- The Conference Report extends through 2006 and expands the AMT exemption amount to \$42,500 for single taxpayers and \$62,550 for joint filers.
- The Conference Report also extends the 15-percent tax rate on capital gains and dividends for two years through 2010. The 0-percent rate for individuals in the bottom two tax brackets will also be extended through 2010.
- With certain revenue offsets, the Conference Report satisfies the provisions of the FY 2006 budget resolution adopted last year (H. Con. Res. 95), which permits the legislation 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.
- On May 10, 2006, the House of Representatives approved the Conference Report by a vote of 244 to 185.

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## Background

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The FY 2006 budget resolution adopted by Congress (H. Con. Res. 95) authorized 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.

On November 15, 2005, the Finance Committee reported favorably an original bill, the Tax Relief Act of 2005 (S. 2020) by a vote of 14 to 6. The bill was 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>.

The Senate considered S. 2020 in November 2005 and approved the bill by a vote of 64 to 33 on November 18, 2005.<sup>1</sup> Subsequently, the House of Representatives approved H.R. 4297, the Tax Relief Extension Reconciliation Act of 2005, by a vote of 234 to 197, on December 8, 2005.

In the Senate, Democrats objected on December 21, 2005, to a customary unanimous consent request to call up H.R. 4297 and amend it with the text of S. 2020 in order to proceed to a conference to reconcile differences in the legislation between the two bodies. Accordingly, the Senate was forced to take up H.R. 4297 and process more than a dozen amendments on February 2, 2006. In addition, Democrats offered a series of motions to instruct conferees on February 13 and 14, 2006.

On February 8, 2006, the House appointed Representatives Thomas, McCrery, Camp (MI), Rangel, and Stark as House conferees, and on February 14, 2006, Senators Grassley, Kyl, and Baucus were appointed Senate conferees. The Conference Committee approved the Conference Report on May 9, 2006. The Conference Report was adopted by the House of Representatives on May 10, 2006 by a vote of 244 to 185.

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## Conference Report Provisions

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The following is a brief overview of the Conference Report's provisions. A complete description of the Tax Increase Prevention and Reconciliation Act of 2005 can be found in House Report 109-455.<sup>2</sup>

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<sup>1</sup>For a summary of S. 2020 as reported, see the Republican Policy Committee's Legislative Notice Number 26, November 16, 2005.

<sup>2</sup>Copies of the conference report, Statement of the Managers, and a summary are available on the Finance Committee's website at: <http://finance.senate.gov/sitepages/legislation.htm>.

## **Title I – Extension and Modification of Certain Provisions**

**Section 101 – Increased Expensing for Small Business.** The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Tax Act) increased the amount that small businesses may expense from \$25,000 to \$100,000 for three years (through 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 businesses) through 2007. The Conference Report extends that enhanced provision through 2009.

**Section 102 – Reduced Rates on Capital Gains and Dividends.** The 2003 Tax Act reduced the tax rates on capital gains and dividends to 15 percent. The rate will be reduced to zero in 2008 for taxpayers in the 10- and 15-percent tax brackets. Without action, these rates will increase after 2008. The Conference Report extends these reduced rates through 2010.

### **Section 103 – Controlled Foreign Corporations.**

- ***Exception under subpart F for active financing and insurance income.*** Subpart F of the tax code imposes immediate taxation on the income earned by foreign subsidiaries of U.S. companies, even if their income has not been repatriated to the United States. A temporary exception from Subpart F applies to active financing and insurance income generated by the U.S.-based financial services and insurance industries and by domestic manufacturers that finance sales of large equipment to foreign customers. The Conference Report extends the active-financing exception for two years, until the end of 2008.
- ***Look-through treatment of payments between related controlled-foreign corporations under foreign-personal-holding-company income rules.*** The Conference Report adds a new temporary exception from subpart F for dividends, interest, rents, and royalties received by one controlled-foreign corporation (CFC) from a related CFC to the extent attributable to non-subpart F income of the payor. The provision will be effective for tax years beginning after December 31, 2005, and before January 1, 2009.

## **Title II – Other Provisions**

**Section 201 – Clarification of Taxation of Certain Settlement Funds.** The Conference Report provides that certain settlement funds established in consent decrees for the sole purpose of resolving claims under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) are to be treated as beneficially owned by the United States government and, therefore, not subject to federal income tax. The provision does not apply to accounts or funds established after December 31, 2010.

**Section 202 – Modification of Active Business Definition under Section 355.** The Conference Report simplifies the “active business test” under section 355 of the tax code with respect to tax-free corporate spin-offs. Under the provision, all corporations in the distributing

corporation's and the spun-off subsidiary's respective affiliated group are considered to determine if the active-business test is satisfied.

**Section 203 – Veterans' Mortgage Bonds.** In the case of qualified veterans' mortgage bonds issued by the States of Alaska, Oregon, and Wisconsin, the Conference Report repeals the requirement that veterans must have served before 1977, and the Conference Report reduces the eligibility period for applying for a loan following release from the military service 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. The provision expanding the definition of eligible veterans applies to financing provided after date of enactment of the bill, and the provision amending the volume limitations applies to allocations of volume limitation made after April 5, 2006. The conference agreement does not amend present law as it relates to qualified veterans' mortgage bonds issued by the States of California and Texas.

**Section 204 – Capital Gains Treatment for Certain Self-Created Musical Works.** The Conference Report provides that, at the election of a taxpayer, the sale or exchange of musical compositions or copyrights in musical works created by the taxpayer's personal efforts is treated as the sale or exchange of a capital asset, resulting in a capital gain or loss. The provision is effective for sales or exchanges in taxable years beginning after the date of enactment and before January 1, 2011.

**Section 205 – Vessel Tonnage Limit.** The tonnage tax is an alternative tax regime for U.S.-flagged vessels that participate in commercial foreign trade. Vessels weighing more than 10,000 deadweight tons may elect into the tonnage tax. The Conference Report reduces the weight threshold to 6,000 deadweight tons, thus allowing more vessels to be competitive by using the tonnage-tax regime.

**Section 206 – Modification of Special Arbitrage Rule for Certain Funds.** The Conference Report extends the grandfather exception from the arbitrage-bond rules for permanent university funds. The limitation on the aggregate amount of bonds that may benefit from the exception remains at 20 percent of the value of the fund. The provision is effective for bonds issued after the date of enactment and before August 31, 2009.

**Section 207 – Amortization of Expenses Incurred in Creating or Acquiring Music or Music Copyrights.** The Conference Report allows music publishers to elect to amortize over five years the advanced payments they make to songwriters. This five-year-amortization method is an alternative to the income-forecast method of accounting under current law for such advances.

**Section 208 – Modification of Effective Date of Disregard of Certain Capital Expenditures for Purposes of 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.

**Section 209 – Modification of Treatment of Loans to Qualified Continuing-Care Facilities.**

The Conference Report provides an exception to the current-law rules requiring the recognition of interest income on certain below-market loans in the case of qualified continuing care facilities. To qualify, the loan must be pursuant to a “continuing care contract” with a “continuing care facility,” both of which are defined in the legislation, and the lender (or his/her spouse) must be at least 62 years old. The provision is generally effective for calendar years beginning after December 31, 2005, with respect to loans made before, on, or after such date; the provision does not apply to any calendar year after 2010.

**Title III – Alternative Minimum Tax Relief**

**Section 301 – Increase in Individual AMT Exemption Amount for 2006.** To prevent new taxpayers from becoming subject to the AMT, 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. The Working Families Tax Relief Act of 2004 extended those exemption amounts through 2005. The Conference Report increases the exemption amounts to \$42,500 for single taxpayers and \$62,550 for married couples filing jointly, effective for 2006.

**Section 302 – Allowance of Non-refundable Personal Tax Credits against AMT Liability.**

Certain non-refundable personal credits (including tax credits with respect to dependent care, the elderly and disabled, Hope Scholarship and Lifetime Learning, and D.C. homebuyers) are effectively disallowed when determining the AMT. Temporary provisions have been enacted in previous years to permit these credits to offset the entire regular and AMT liability. Those provisions expired at the end of 2005. The Conference Report allows the non-refundable personal tax credits to the full extent of the individual’s regular tax and AMT for 2006.

**Title IV – Corporate Estimated Tax Provisions**

**Section 401 – Time for Payment of Corporate Estimated Taxes.**

- ***Increase corporate estimated tax payments due in July through September for certain corporations.*** In case of a corporation with assets of at least \$1 billion, the Conference Report increases payments due in:
  - July, August, and September, 2006, to 105 percent of the payment otherwise due, and the next required payment is reduced accordingly;
  - July, August, and September, 2012, to 106.25 percent of the payment otherwise due, and the next required payment is reduced accordingly; and
  - July, August, and September, 2013, to 100.75 percent of the payment otherwise due, and the next required payment is reduced accordingly.

- ***Delay due date until October 1 for certain corporate estimated taxes that are otherwise due on September 15.*** With respect to corporate estimated tax payments due on:
  - September 15, 2010, the Conference Report provides that 20.5 percent shall not be due until October 1, 2010; and
  - September 15, 2011, the Conference Report provides that 27.5 percent shall not be due until October 1, 2011.

## **Title V – Revenue Offset Provisions**

### **Section 501 – Application of Earnings Stripping Rules to Partners That Are C**

**Corporations.** The Conference Report codifies proposed Treasury Department regulations by providing that, in the case of a corporation that owns, directly or indirectly, an interest in a partnership, the corporation’s share of the partnership’s liabilities, interest income, and interest expense flow through to the corporation for purposes of applying the earnings stripping rules to the corporation. The provision is effective for taxable years beginning on or after the date of enactment.

**Section 502 – Reporting of Interest on Tax-Exempt Bonds.** Under the Conference Report, interest paid on tax-exempt bonds is subject to information reporting in a manner similar to interest paid on taxable obligations. The provision is effective for interest paid on tax-exempt bonds after December 31, 2005.

**Section 503 – Five-Year Amortization of Geological and Geophysical Costs for Major Integrated Oil Companies.** The Conference Report lengthens the two-year amortization period for Geological and Geophysical (G&G) costs under current law to five years for certain major integrated oil companies. 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 refinery of 15 percent or more. The provision applies to amounts paid or incurred after date of enactment.

**Sections 504-506 – Treatment of Distributions Attributable to FIRPTA Gains.** The Conference Report modifies the scope of the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”) to apply to qualified investment entities with significant interests in United States real property. The Conference Report also modifies the application of FIRPTA for investors that own not more than 5 percent of certain qualified investment entities, and it restricts the ability of a foreign investor to avoid the FIRPTA tax rules by investing in a tiered qualified investment entity. Additionally, the Conference Report imposes a FIRPTA withholding on foreign investors that engage in sale and repurchase transactions in order to avoid capital gain distributions that would otherwise be subject to withholding.

**Section 507 – Modification of Rules Applicable to Distributions Involving Qualified Investment Companies.** The Conference Report bars tax-free treatment of certain spin-offs in which either the distributing corporation or the controlled corporation is a “disqualified

investment corporation.” Under the Conference Report, a disqualified investment corporation is defined as having investment assets that are two-thirds or more of the value of the corporation’s total assets. However, for distributions occurring within one year after the date of enactment, the investment asset threshold is three-fourths.

**Section 508 – Loan and Redemption Requirements on Pooled-Financings.** The Conference Report 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.

**Section 509 – Partial Payments Required with Submissions of Offers-In-Compromise.** The Conference Report requires a taxpayer to make partial payments to the Internal Revenue Service (IRS) while the taxpayer’s offer-in-compromise is being considered. For lump-sum offers, taxpayers must make a down payment of 20 percent of the amount of the offer. 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 will be returned to the taxpayer as unprocessable, and the IRS is permitted to take immediate enforcement action. The Conference Report 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 provision is effective for offers-in-compromise submitted on and after the date that is 60 days after the date of enactment.

**Section 510 – Increase in Age of Minor Children Whose Unearned Income is Taxed As if Parent’s Income.** The Conference Report 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”). The Conference Report provides that the kiddie tax does not apply to a child who is married and files a joint return for the taxable year. The provision also creates an exception to the kiddie tax for distributions from certain qualified disability trusts. The provision applies to taxable years beginning after December 31, 2005.

**Section 511 – Imposition of Withholding on Certain Payments Made by Government Entities.** The Conference Report requires withholding on certain payments made by the government of the United States, a state, a political subdivision thereof, and an instrumentality of the foregoing (including multi-State agencies) to any person providing property or services to such government entity. The rate of withholding is 3 percent on all payments (including all payments made in connection with a government voucher or certificate program) regardless of whether the payments are for property or services. 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 (e.g., food vouchers or medical assistance to low-income individuals). In addition, 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 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; and certain payments to government employees. The proposal applies to payments made after December 31, 2010.

**Section 512 – Elimination of Income Limitations on Roth IRA Conversions.** The Conference Report eliminates the income limits under current law on conversions of traditional individual retirement accounts (IRAs) to Roth IRAs, allowing taxpayers to make such conversions without regard to their adjusted gross income. The provision applies to conversions that occur in 2010. For conversions occurring in that year, a taxpayer may generally include the additional income resulting from the IRA conversion in equal amounts over a two-year period – in 2011 and 2012.

**Section 513 – Repeal of FSC/ETI Binding Contract Relief.** While repealing the United States' Foreign Sales Corporation (FSC) and extraterritorial income (ETI) tax regimes, the JOBS Act provided certain transition relief for companies benefiting from these tax systems. The Conference Report repeals both the FSC and the ETI binding-contract relief (the general transition rule remains in effect), effective for taxable years beginning after date of enactment. These changes are intended to comply with the recent ruling by the World Trade Organization (WTO) Appellate Body that found that the binding-contract relief is a prohibited export subsidy, enabling the European Union to impose tariffs on U.S. exports if the provision is not repealed.

**Section 514 – Modification of Wage Limitation for the Deduction for Domestic Production.** Under present law, the manufacturing deduction is limited to 50 percent of a business' employee wages reported on Form W-2. The Conference Report modifies the wage limitation such that taxpayers may only include amounts that are properly allocable to domestic-production gross receipts. In addition, as a simplification measure, the Conference Report repeals the special limitation on wages treated as allocated to partners or shareholders of passthrough entities.

**Section 515 – Modification of Exclusion for Citizens Living Abroad.** The Conference Report modifies the foreign-earned-income exclusion and housing allowance. First, the income exclusion is indexed for inflation starting in 2006 (rather than 2008 under current law). Second, the base housing amount used in calculating the foreign-housing-cost exclusion in a taxable year is changed to 16 percent of the amount of the foreign-earned-income exclusion limitation (instead of 16 percent of the grade GS-14, step 1 amount, under current law). Third, income excluded as either foreign-earned income or as a housing allowance is included for purposes of determining the marginal tax rates applicable to non-excluded income.

**Section 516 – Tax Involvement of Accommodation Parties in Tax Shelter Transactions.** The Conference Report 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.

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## Cost

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The Joint Committee on Taxation (JCT) estimates that the Conference Report will reduce federal tax revenues by a net \$10.76 billion in FY 2006 and by \$69.96 billion over five years. A copy of the JCT's revenue estimate is available at: <http://www.house.gov/jct/x-18-06.pdf>.

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## Administration Position

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Upon House passage of the Conference Report, the White House released the following statement by the President:

“The tax cuts we passed in recent years are working to fuel America’s economic expansion. Our pro-growth policies have helped the economy create more than 5.2 million jobs since August of 2003, and last year our economy grew faster than that of any other major industrialized nation. By extending key capital-gains and dividends tax relief, the House has taken an important step to continue to help hard-working Americans and to keep our economy strong and growing. I appreciate the House Leadership and Chairman Bill Thomas for their hard work.

“I urge the Senate to vote swiftly so that I can sign this bill into law and put a stop to a massive tax hike that would be disastrous for small businesses, our economy, and all working Americans.”